The SMSF: a mechanism for self-directed member investment

by

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Submitted in fulfilment of the requirements for the Degree of Doctor of Philosophy

University of Tasmania, March 2017

Statements

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Abstract

Retirement savings in Australia held through regulated superannuation are substantial and projected to exceed a staggering $9 trillion by 2040.[1] The sheer magnitude of assets held in this custody underscores the need for scrutiny of its governing laws. As superannuation law is derived from a number of sources, it is an unwieldly task to address all aspects in a single piece of research. The concern of this thesis is the legal framework adopted by the self-managed superannuation fund (SMSF), a particular type of regulated superannuation fund operating in Australia.

In addressing the subject matter, significant attention is given to context, seeking to capture the substance of the SMSF, from which the suitability of its adopted trust structure is evaluated. In this regard, at a most foundational level the essence of the SMSF is a vehicle to hold superannuation savings. Accordingly, to truly understand the nature of the SMSF it is instructive to trace its roots through broader historical analysis of superannuation in Australia. Along with a gradual development to form a component of retirement incomes policy, this thesis reveals a theme that beyond the element of compulsion, the existence of regulated superannuation is tied to the co-dependencies of taxation concessions and regulatory constraint.

For the SMSF this co-dependency is particularly significant, with regulation adopting more of a compliance, rather than prudential flavour consistent with high levels of member engagement and involvement in fund decision making.[2] The existence of taxation concessions to encourage participation, combined with the fact that superannuation was initially regulated through the taxation power vested in the Commonwealth,[3] suggests that predecessors of the SMSF are identifiable in historic taxation legislation. Beyond the influence of taxation, however, the ultimate driver for their separate recognition has proven to be the introduction of prudential regulation.[4] This reflected a "one-size-fits-all" legislative approach, despite the limited role that member assurance plays for the SMSF, or its roots as a tax structure operating subject to statutory constraint.

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1 Commonwealth of Australia, *Financial System Inquiry Interim Report* (2014) 2-84. The precise rate of future growth in superannuation is difficult to estimate. Some estimates have factored in higher rates of growth that suggest superannuation fund assets would exceed $12 trillion by the late 2030s.

2 Commonwealth of Australia, *Super System Review Final Report, Part Two: Recommendation Packages* (2010) Ch 1, 6.

3 *Commonwealth of Australia Constitution Act 1900* (Cth) s 51(ii).

4 This regime has been based on the Commonwealth's constitutional powers pertaining to old age pension and corporations. Refer *Commonwealth of Australia Constitution Act 1900* (Cth) ss 51(xxiii), (xx).

Adopting a member-focussed regulatory approach,[5] this thesis ultimately captures the substance of the SMSF as a mechanism for self-directed member investment, encouraged through taxation concessions but limited by restrictions prescribed by the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA). From this springboard, it is possible to judiciously consider the suitability of its legal framework, albeit one that is reliant on a trust in need of "stretching" to achieve what has been asked of it. The thesis accordingly deconstructs the trust in this context, targeting difficulties in translating fiduciary and other trust law duties to the substance of the SMSF. The analysis reveals a need for positive steps to resolve the strain between form and substance.

This thesis contains primary and secondary alternatives to redress the unsuitability of the trust, implementation of which will be hostage to the capacity and willingness of the legislature to embrace reform. As a compromise of "tinkering" around the edges, the secondary alternative seeks to retain the trust, but to improve alignment with the SMSF's substance through further legislative intervention. There is a sense of resignation with this recommendation, to do the best with a framework that is fundamentally inappropriate for its purpose. The preferred approach is to fully endorse the SMSF's substance through the adoption of a purely legislative-based existence. Such a significant change would need extensive consultation and open-mindedness, enabling the issue to ascend beyond the tendency for superannuation reform to be stalled in a quagmire of competing ideologies, with different interest groups merely seeking to further their own position.

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5 For endorsement of this approach refer Commonwealth of Australia, *Super System Review Final Report*, *Part Two: Recommendation Packages* (2010) Ch 1, 5-9.

Acknowledgements

I am extremely appreciative of the significant assistance and guidance of my supervisor, Professor Gino Dal Pont. I have enjoyed our regular discussions spanning both superannuation and taxation law, along with his general support and encouragement.

I am grateful to the University of Tasmania Law School for providing the facilities to assist me in the completion of this thesis, with particular thanks to the staff of the Law Library and for the funding I received to attend a superannuation related conference.

I would like to acknowledge and thank my partner and more extended family for their patience while I have been completing this thesis.

It has been a privilege to be given the opportunity to undertake a PhD.

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LIST OF ACRONYMS

ABN	Australian Business Number
ACTU	Australian Council of Trade Unions
ALP	Australian Labor Party
ALRC	Australian Law Reform Commission
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investment Commission
ATO	Australian Taxation Office
AWOTE	Average Weekly Ordinary Times Earnings
BRP	Business Real Property
CAC	Conciliation and Arbitration Commission
CA	*Corporations Act 2001* (Cth)
CGT	Capital Gains Tax
CMC	Central Management and Control
ED	Exposure Draft
ELC	Economics Legislation Committee
ESF	Excluded Superannuation Fund
ETP	Employment Termination Payment
FCT	Commissioner of Taxation
FLA	*Family Law Act 1975* (Cth)
FSI	Financial System Inquiry
GFC	Global Financial Crisis
ISC	Insurance and Superannuation Commission
ITAA1915	*Income Tax Assessment Act 1915* (Cth)
ITAA1915-1921	*Income Tax Assessment Act 1915-1921* (Cth)
ITAA1922	*Income Tax Assessment Act 1922* (Cth)
ITAA1922-1934	*Income Tax Assessment Act 1922-1934* (Cth)
ITAA1936-1943	*Income Tax Assessment Act 1936-1943* (Cth)
ITAA1936	*Income Tax Assessment Act 1936* (Cth)
ITSSCA1936-1951	*Income Tax and Social Services Contribution Assessment Act 1936-1951* (Cth)
ITSSCA1936-1952	*Income Tax and Social Services Contribution Assessment Act 1936-1952* (Cth)
ITSSCA1936-1961	*Income Tax and Social Services Contribution Assessment Act 1936-1961* (Cth)
ITSSCA1936-1963	*Income Tax and Social Services Contribution Assessment Act 1936-1963* (Cth)
ITSSCA1936-1964	*Income Tax and Social Services Contribution Assessment Act 1936-1964* (Cth)
ITAA1997	*Income Tax Assessment Act 1997* (Cth)
MPT	Modern Portfolio Theory
OSSA	*Occupational Superannuation Standards Act 1987* (Cth)
OSSR	*Occupational Superannuation Standards Regulations 1987* (Cth)
RBL	Reasonable Benefit Limit

RSE	Registrable Superannuation Entity
SMSF	Self-managed Superannuation Fund
SELC	Senate Economics Legislation Committee
SAF	Small APRA Fund
SG	Superannuation Guarantee
SGC	Superannuation Guarantee Charge
SISA	*Superannuation Industry (Supervision) Act 1993* (Cth)
SISR	*Superannuation Industry (Supervision) Regulations 1994* (Cth)
TFN	Tax File Number

PART ONE – CONTEXT IDENTIFIED

CHAPTER ONE: INTRODUCTION

1.1 Basis for the research

Since the introduction of the old age pension in 1909 the Australian retirement income system has evolved from one that primarily fulfilled a role of poverty alleviation, to one that combines private and public arrangements to meet a variety of retirement income needs. Australia currently has a "three pillar" retirement income system, comprising the old age pension, compulsory saving through a superannuation guarantee, and voluntary saving, through superannuation and other means.[1] The 'three pillar' approach is intended to satisfy the minimum retirement income needs of the Australian public, but also to furnish individuals with the opportunity to enhance their retirement incomes.

The subject matter of investigation in this thesis is the self-managed superannuation fund (SMSF) which, by virtue of its ability to accept both employer and voluntary contributions, falls across the second and third pillars of the retirement income system. Although aspects of these pillars have been subject to various reviews, coverage of the SMSF is often prone to repeating superficial and well-worn statements of subjective opinion. At one extreme, the SMSF might be described as a mistake, giving potentially unskilled or misguided members of the public control over one of the largest investments they will make during their life. Alternatively, it may epitomize Commonwealth Government's (Government) aspirational goal for all citizens, having them engaged and capable of looking after their own financial future in retirement rather than relying on others.

Ideological views aside, a broad justification for this thesis is that the SMSF has, with limited exception, not attracted meaningful academic legal research. Beyond the general lack of academic writing, there are also strong public interest reasons to support further enquiry, particularly given the quantum of retirement savings held in SMSFs[2] and their tax concessional treatment.[3] These features give rise to a broad range of potential areas for

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1 See Australian Government Treasury, *Australia's Retirement Income System* (2014) <http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/supercharter/Report/Chapter-1>.

2 As at 30 June 2016 SMSFs held $621.7 billion of assets under management, being approximately 30% of the $2,109.9 billion in total assets held by superannuation entities in Australia at that time. Refer Australian Prudential Regulation Authority, 'Statistics' [2016] (June) *Quarterly Superannuation Performance* 7.

3 The taxation concessions for a SMSF, along with other complying superannuation funds, are broadly contained in the *Income Tax Assessment Act 1997* (Cth) Part 3-30. The rates of tax payable by trustees of a SMSF being 15% in respect of the low rate component and 45% in respect of the non-arm's length component are prescribed in the *Income Tax Rates Act 1986* (Cth) s 26. Refer section 2.4.2 of this thesis for discussion the different categories and taxation treatment of superannuation funds over time.

investigation. A fundamental question, however, is whether the trust structure is a suitable legal framework for the SMSF. The matter is fundamental because, by reason of statutory prescription, the trust does currently provide the basis for all SMSFs to exist, and is the foundation stone upon which their regulation builds to deliver on the objectives of the retirement income system.

This thesis considers the suitability of the trust and obligations that ensue from the adoption of that structure by reference to the SMSF context, which is used to reveal the substance of the arrangement. The importance of substance is particularly evident in practice, reflecting an apparent disconnect and misconception by SMSF participants as to the significance of the trust. For many participants, the legal ramifications of the trust structure receive superficial attention, perhaps an irrelevance, displaced by views of the SMSF that are consistent with it being a mechanism for member-directed investment to be operated within certain statutory constraints. The Australian Taxation Office's (ATO) compliance-based focus to identify and mitigate SMSF risks is also consistent with that characterisation, reluctant to evaluate investment choices or become involved in resolving trustee-beneficiary disputes.[4]

The significance of this tension, and whether it presents a sufficient basis to reform the legal framework of the SMSF, can only be evaluated through research, taking into account the SMSF's historical development, purpose and operation. Accordingly, these contextual matters receive very detailed consideration in this thesis so as to make an informed and defensible response. In doing so, this thesis grasps a unique opportunity to investigate the impact of legislative interference through regulation and taxation law as a single piece of research. Those matters are of particular interest to the author, both from an academic and practice perspective. Moreover, the research is timely, given the growing scrutiny that regulated superannuation, including the SMSF, receives concerning the affordability of Government tax expenditures to support member participation. This scrutiny may also serve to increase receptiveness to suggestions for structural reform.

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4 For further information on the ATO's compliance approach see Australian Taxation Office, *How your SMSF is regulated* (16 June 2015) <https://www.ato.gov.au/super/self-managed-super-funds/administering-and-reporting/how-we-help-and-regulate-smsfs/how-your-smsf-is-regulated/>; Australian National Audit Office, 'The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds'(Audit Report No 52, 2007); Australian National Audit Office, 'The Australian Taxation Office's Approach to Managing Self-Managed Superannuation Fund Compliance Risks' (Audit Report No 13, 2007-08).

1.2 Objectives

The research objectives of this thesis are two-fold, albeit linked. The first is to examine the suitability of the trust as a legal framework for the SMSF. In the event that the framework is held to be unsuitable for this purpose, the second objective is to make recommendations for improvement.

In addressing the first objective, a preliminary task is to understand the historical underpinnings of the SMSF to capture the formative aspects of its existence. The presence of tax concessions is fundamental for the SMSF and invites further enquiry to locate a precursor vehicle in historic taxation legislation before its more easily identifiable emergence in prudential regulation. Having identified how the SMSF developed and its particular features, this context is used to reveal the substance of the relationship, which in-turn supports the conclusion that the trust falls short of providing a suitable structure.

The second objective follows from the conclusions drawn in relation to the first objective. Given the unsuitability of the trust, it would be deficient not to extend the analysis to include recommendations to improve the current legal framework. Two possible alternatives are explored. The first is to pursue further legislative intervention to limit the features of the trust that are inappropriate for the SMSF, supported by comparable approaches already applied in other legislative contexts. The second, and ultimately preferred approach, is for a complete endorsement of the SMSF substance through the adoption of a purely legislative-based existence.

Beyond practical constraints that preclude an exhaustive analysis of all conceivable reform options, the selected alternatives have been chosen for two reasons. The first was selected to reflect a reality that, despite adding complexity, deficiencies in superannuation and taxation law have commonly been resolved in the past by adding further legislative prescription.[5] The second was selected on the basis of its flexibility to produce a legal framework that most suited to the SMSF, unhindered by the characteristic features of existing legal structure. A new statutory framework reflects the alternative that remains after all existing structures are

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5 Commonwealth of Australia, 'Re:think, Tax discussion paper' (2015) Ch 10, 167. Initiatives such as the Tax Law Improvement Project illustrate the fact that further complexity may arise despite an underlying objective of simplification. See Adrian Sawyer, 'Rewriting tax legislation – Can polishing silver really turn it into gold?' (2013) 15(1) *Journal of Australian Taxation* 1.

eliminated.[6] It proceeds on the basis that untailored structures are likely to carry some inherent unsuitability for the SMSF, and on that basis can offer only an inferior solution.

1.3 Methodology

A review of existing literature revealed very limited academic writing on the subject of SMSFs. Investigation of superannuation more generally revealed the amenability of traditional legal research methodologies, utilising surveys and interviews to garner empirical data. However, this thesis has not adopted that approach. It is a foundational piece of legal research that addresses the suitability of the SMSF legal framework. It is informed by the legal principles that follow the adoption of the trust and by various matters of context particular to the SMSF.

The thesis methodology has been derived from an observation that, in trust law, context is critical. Arguably, this is nowhere more apt than when dealing with a superannuation fund based on a trust structure. In these circumstances, courts have displayed a willingness to be informed by the unique context in which the trust plays its role, avoiding potentially misguided conclusions based on principles suited to other applications of the trust.[7]

Adopting this approach, the first step in the methodology is to capture the essence of the SMSF. To ensure that this foundation is strong and avoid subsequent steps being misinformed the analysis must be comprehensive. It commences broadly with basic superannuation concepts, before narrowing to address the historical tax and regulatory environment from which the SMSF was born and ultimately its present-day existence as a retirement savings vehicle. These contextual matters generate a matrix of fact, going beyond the trust form to reveal the substance of the relationship and explain what the SMSF is about.

The second step considers how trust law principles apply to the SMSF. However, unlike case law authority that would tend to narrowly consider this question in light of a particular trust

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6 There is some precedent for that approach in *Twinsectra Ltd v Yardley and others* [2002] 2 AC 164, 192 wherein Lord Millett upon dissecting the nature of a *Quistclose* trust observed: "As Sherlock Holmes reminded Dr Watson, when you have eliminated the impossible, whatever remains, however improbable, must be the truth".

7 *Mettoy Pension Trustees Ltd v Evans* [1990] 1 WLR 1587, 1610-1611 (Warner J); *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 271-272 (FC). See further Robert Walker, 'Some Trust Principles in the Pensions Context' in AJ Oakley (ed), *Trends in Contemporary Trust Law* (Clarendon Press, 1996) 123; David Hayton, 'Pension Trusts and Traditional Trusts: Drastically Different Species of Trusts' (2005) 69 *The Conveyancer and Property Lawyer* 229.

deed, the analysis more generally considers the suitability of the principles given the characteristics of the SMSF revealed at step one.

The final step in the methodology is to provide a constructive response to the conclusion at step two that the existing reliance on the trust is unsuitable for the SMSF. The suggestions are not intended to be exhaustive, with a primary and secondary alternative for reform being recommended. It is intended that these alternatives would create a platform for policy makers to embark on a consultation process, inviting further research to collect empirical data on the case for change from the public, Government and industry, taking into account the findings in this thesis.

1.4 Structure

In order to achieve its objectives, this thesis is structured incrementally to build a case for legislative reform. Chapter 2 lays the initial foundation by dissecting the meaning of superannuation and charting its historical development. This serves to unveil the broad context of superannuation in Australia, and concurrently limit the scope for recommendations to unwittingly reinvent the past. Along with the utilisation of a trust framework, a theme is revealed that beyond the element of compulsion, the existence of regulated superannuation is tied to the co-dependencies of taxation concessions and regulatory constraint. The proceeding chapters develop this proposition by reference to both the substance of the SMSF and its legal framework.

Chapter 3 narrows the analysis to capture the substance of SMSF by reference to various matters of context. Adopting a similar approach to Chapter 2, this is achieved to some extent by a historical analysis. The importance of taxation concessions to attract participation, combined with the fact that superannuation was initially regulated through the taxation power vested in the Commonwealth,[8] suggests that predecessors of the SMSF are identifiable in historic taxation legislation. Beyond the influence of taxation, however, the analysis reveals the ultimate driver to their separate recognition has proven to be the introduction of prudential regulation.[9] Building upon these formative origins, a dissection of the SMSF by reference to statistical data brings clarity on how the vehicle is utilised and gives the analysis a degree of currency.

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8 *Commonwealth of Australia Constitution Act 1900* (Cth) s 51(ii).
9 Based on the *Commonwealth of Australia Constitution Act 1900* ss 51(xxiii), (xx).

The research is then channelled in Chapter 4 to address the suitability of the trust structure upon which the SMSF relies for its legal framework. The question of suitability is determined by reference to the substance of the SMSF, and thus builds upon the conclusions in Chapter 3. The trust's unsuitability for this purpose is substantiated through a deconstruction of its features in this context, targeting the obstacles associated with translating fiduciary and other trust law duties. This in turn prompts a need to resolve the strain between form and substance.

Chapter 5 builds the foundations to justify a substance over form approach in devising a suitable legal framework for the SMSF. This is achieved by extending the work of the *Super System Review*[10] (Cooper Review), which supported a member-focussed approach to regulated superannuation and identified the SMSF to be an option for individuals seeking full responsibility and control over their retirement savings. This characterisation of the SMSF, yet failure to recommend change to its legal framework, invites consideration of other contexts where the unsuitable features of the trust have successfully been modified by statutory intervention. It is resolved that these approaches could be adopted to improve the suitability of the trust framework for the substance of the SMSF.

While the unsuitability of the trust for the SMSF might be overcome to some extent by statutory intervention, the preferred solution is revealed in Chapter 6. The proposal is to abandon the trust and fully endorse the SMSF substance through the adoption of a purely legislative-based existence. Admittedly, this presents a radical departure from the comfort of the trust, though that is a comfort which this thesis has shown to be misplaced. Some final remarks are then made on the likelihood of the recommendations being adopted, contributing realism in terms of the current political landscape and divergent views on the future of the retirement income system.

1.5 Scope of the research

The scope of this thesis is evident from the structure outline, but to avoid misconception it is useful to clarify the parameters under which the research objectives are pursued. At a most philosophical level, it is important to identify that this thesis does not concern itself with issues surrounding the fairness of the current superannuation arrangements in Australia and the level of Government support they receive. While legal discourse might validly consider those matters, as important areas of social justice, the research proceeds on the basis that the basic policy settings surrounding superannuation will remain in place.

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[10] Superannuation Review Panel, *Super System Review* (2009).

The investigation contains significant analysis of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA), as the principal statute regulating SMSF activity. However, even though the SISA is fundamentally a prudential enactment, the research focus is not concerned with evaluating the assurance given to members that their superannuation interests are safe. The relevance of safety is limited to the broader public interest that SMSF participants do not jeopardise the success of the retirement income system and increase reliance on the old age pension. In the SMSF context, the SISA can be viewed more as a compliance requirement, setting out a series of rules that must be adhered to in order for participants to secure a desired taxation outcome.

A further narrowing of scope is required given that the SISA applies to a "superannuation entity", an expression that includes a regulated superannuation fund, an approved deposit fund and a pooled superannuation trust.[11] The last two of these vehicles adopt a trust framework, but their differentiated purpose and restricted scope of activity explains why they are not subject to detailed consideration.[12] The relevant category therefore is the "regulated superannuation fund", which includes a range of different funds that adopt a trust structure, including the SMSF, public offer funds and employer-sponsored funds.[13] Other than for the objective of providing historical context or to contrast their position with the SMSF, these other types of superannuation fund are not a focus of the research. The position of the SMSF is unique and can be given separate scrutiny, as is evident from its own definition in the SISA.[14]

Beyond the SISA, various laws affect the provision of superannuation through the SMSF. While taxation law is arguably the most significant of these due to its underlying role to encourage participation, corporations law and other more incidental areas such as family law and stamp duty have roles to play. While the thesis does consider these laws, it does so primarily in the limited context of addressing the suitability of the trust and in developing recommendations for reform, and not in any exhaustive sense. This approach ensures that

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11 SISA s 10.

12 Broadly, an approved deposit fund is a rollover vehicle for deposits of amounts from eligible termination payments, while a pooled superannuation trust holds assets that have been invested in it by other superannuation entities. Neither entity may accept contributions from an employer or employee. Refer definitions SISA s 10(1).

13 These other funds are employer-sponsored funds (refer SISA s 16) or public offer funds (refer SISA s 18). More generally they are described as Australian Prudential Regulation Authority regulated funds.

14 ss 17A, B.

superfluous materials are not unnecessarily traversed, which is particularly important given the complexity and volume of law in these areas.

It is not intended that the reforms proposed in this thesis exhaust all possible solutions or suggested that they could not be subject to further variation. In fact, it is very likely that modification and detail would be added following a period of consultation with all relevant stakeholders. However, the salient point is that viable solutions do exist and should be pursued with vigour to improve the existing legal framework. Their ultimate implementation will cross the boundary of legal analysis in this thesis to enter the political and policy settings in which reform invariably occurs. While this thesis does make some concluding remarks on these settings, their purpose is to confirm that the recommendations are not so unrealistic or impractical as to have no likelihood of adoption.

1.6 Existing literature

The topics of superannuation and taxation law are broad. Unsurprisingly, there has been significant academic research to address a range of issues coming under such a large umbrella. A major taxation related research topic has been the issue of taxpayer compliance costs,[15] given the frequently repeated mantra that the Government endeavours to reduce "red tape" for the community.[16] Other taxation studies have considered issues such as integrity of the taxation system.[17] However, there has been limited historic academic coverage of taxation in a superannuation context.[18]

Academic research into superannuation law has typically focussed on superannuation funds that are regulated by the Australian Prudential Regulation Authority (APRA-regulated funds), which necessarily attract a particular theme of issues consistent with the strong prudential basis to their regulation. While there are some instances where such enquiry does narrow to address SMSFs, this has largely been to clarify that they are specifically excluded from the

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15 Maryann Richardson and Adrian Sawyer, 'A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects' (2001) 16 *Australian Tax Forum* 137.

16 For recent Government efforts in this regard refer *Treasury Legislation Amendment (Repeal Day) Act 2015* (*No. 2) 2015* (Cth).

17 A partnership between the Australian Taxation Office and the Australian National University established the Centre for Tax System Integrity, which ran from 1999 to 2005. This Centre undertook research on how voluntary taxpaying cultures can be maintained and why cooperation and contestation occur within the tax system.

18 David Trende, *The Taxation Implications of Superannuation Funds* (Master of Administration Thesis, Monash University, 1971); Jeff Pope and Prafula Fernandez, 'The Compliance Costs of the Superannuation Surcharge Tax' (2003) 18 *Australian Tax Forum* 537; Josephine Cleary, *The Evolution of the Regulation Governing Superannuation Funds Since 1936* (PhD Thesis, Bond University, 2010).

scope of investigation.[19] One occasion where the SMSF regulation was in fact the primary subject matter, the research specifically excluded any detailed analysis of the trust structure upon which the SMSF is based.[20] Although a number of SMSF related articles have appeared in legal and social science journals, they have similarly not contemplated the suitability of the trust.[21]

Despite a dearth of formal research, it is fortunate that SMSFs receive regular media coverage and have been considered in a number of Government-sponsored reviews. Amongst others, a significant contribution in recent times has come from the Cooper Review. This work receives particular attention in Chapter 5 of the thesis. It identifies and develops a range of SMSF-related issues, including whether the trust structure should be retained. Although a recommendation was made on this point, it was supported by limited explanation and a reluctance to thoroughly scrutinise the issue, perhaps attracted by the safety of maintaining the status quo. This deficiency is frequently shared by the media coverage of SMSFs, with articles often adopting attention-grabbing headlines supported by limited analysis or objective evaluation of the relevant facts.[22]

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19 Lisa Butler, *The Priority of the Trust in the Age of Superannuation* (PhD Thesis, University of Tasmania, 2003) 19.

20 Josephine Castillo, *Entrusting the Trustees: The Regulation of SMSFs in Australia* (PhD Thesis, University of Tasmania, 2013) 15.

21 See, for example, Robert Severino, 'Self-Managed Superannuation – An Exceptional Product' (2004) 15(8) *Superannuation Law Bulletin* 109; Tom Valentine, 'Regulation of DIY Superannuation Funds' (2004) 37(2) *The Australian Economic Review* 215; Stephen Godding, 'Legal Aspects of Self-Managed Superannuation Funds' (2005) 19(2) *Commercial Law Quarterly* 29; Peter Phillips, 'Self-Managed Superannuation Funds: Theory and Practice' (2007) 6(1) *Journal of Law and Financial Management* 8; Peter Phillips, Alex Cathcart and John Teale, 'The Diversification and Performance of Self-Managed Superannuation Funds' (2007) 40(4) *The Australian Economic Review* 339; Daniel Butler, 'Succession to a SMSF' (2010) 44(8) *Taxation in Australia* 474; Peter Phillips, 'Will Self-Managed Superannuation Fund Investors Survive?' (2011) 44(1) *The Australian Economic Review* 51; Josephine Castillo, 'The SMSF Trustee-members' (2012) 40(3) *Australian Business Law Review* 177; Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper*.

22 See, for example, Tony Rumble, 'Industry gangs up on SMSFs', *Australian Financial Review*, 8 December 2010, 63; Sally Patten, 'DIY super: an uncontrolled gravy train', *Australian Financial Review*, 3 September 2011, 47; Robert Harley, 'Tax changes may unleash DIY monster', *Australian Financial Review*, 15 September 2011, 47; Gillian Bullock, 'Changes no excuse to hold off DIY super' *Weekend Australian*, 14 April 2012, 30; Annette Sampson, 'Irked super funds let fly at DIY crowd', *Sydney Morning Herald*, 15 September 2012, 13; Gareth Hutchens and Ben Butler, 'Dangers rising on self-managed super, says Treasury head', *The Age* (Melbourne), 29 November 2012, 3; Sally Pattern, Katie Walsh and Claire Stewart, 'Red flag over booming DIY super sector', *Australian Financial Review*, 26 March 2013, 8; Sally Patten, 'A do-it-yourself financial bubble', *Australian Financial Review*, 26 September 2013, 48; Michael Pascoe, 'Self-managed super in regulator sights', *Sydney Morning Herald*, 2 December 2014, 28; Jackie Pearson, 'SMSF boot camp', *Australian Financial Review*, 17 April 2015, 36; Joanna Mather and Jacob Greber, 'SMSFs resist calls to curb property dealing', *Australian Financial Review*, 15 December 2015, 6; James Kirby, 'It's D-Day for DIY funds as the big guns fight back', *Weekend Australian*, 12 March 2016, 34; James Frost, 'SMSF fortress', *Smart Investor*, *Australian Financial Review*, 18 March 2016, 25.

In light of these observations, it is clear that no pre-existing academic study has addressed the SMSF in the manner adopted by this thesis. To the extent that this has occurred in some Government or privately sponsored enquiry, then significant limitations can be identified. Ultimately, this thesis is unique in that it brings taxation and superannuation together while investigating the suitably of the trust as the legal framework for the SMSF. That suitability is resolved by reference to the substance of the arrangement, which is a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions.

CHAPTER TWO: SUPERANNUATION EXPLAINED

2.1 Introduction

This chapter lays a foundation from which subsequent chapters of this thesis build. It commences by examining the meaning of the word "superannuation", a term that regularly finds its way into private discussion, the media and political discourse. Self-interest might reasonably lead individuals to conceive that superannuation is something that belongs to them, further thought as to whether they have enough and possibly a comparison of their own position to others. To evaluate these considerations and more importantly the particular matters addressed in this thesis it is vital to clarify what "superannuation" entails. This presents some challenge, given its ability to evolve over time to encompass developing commercial and regulatory practices of a modern society. Nonetheless, an explanation of superannuation provides the point of commencement from which the thesis will progress.

A further task is to explain the nature of a "superannuation fund". This phrase is inextricably linked to superannuation and has the ability to captivate the attention of many individuals in the community that are engaged with their retirement income affairs. Yet for others, it may draw anxiety and confusion. Given the taxation and regulatory focus of this thesis, it is fortunate that the corresponding legislative regimes specify the necessary characteristics of a superannuation fund for each purpose. While relying on the trust legal framework, a historical review shows that statutory prescription has become overwhelmingly important. It demands particular features and has created legislative sub-categories, such as a "complying superannuation fund", that are critical to access a concessional taxation treatment.

Beyond these preliminary matters, broad context is developed by examining the history of superannuation in Australia. In this regard, the origins of superannuation are shown to commence as benefits to employees in private-sector employment, before expanding to individuals employed in the government sector and then to self-employed persons. In terms of coverage, the principal growth driver has been occupational superannuation, developing to include award superannuation and later the creation of a compulsory Superannuation Guarantee (SG). These initiatives took place in an environment in which Commonwealth Government (Government) was slowly moving to formulate a comprehensive retirement incomes policy.

Coinciding with these developments, taxation measures have consistently played an important role to encourage participation in superannuation. Yet, at a detailed level the extent of the concessional taxation treatment offered has varied over time, typically becoming less generous as it moves towards its present day form. The scope of taxation's role has also narrowed from its early dual revenue and regulatory function. Eventually the regulatory component was moved outside the *Income Tax Assessment Act 1936* (Cth) (ITAA1936) to better accommodate the growing importance of prudential objectives.[1] After a period of incremental legislative change, simplification and streamlining of superannuation became an important focus, particularly to address taxation complexities.[2] Most recently attention has shifted to limit the revenue cost of the taxation expenditures supporting superannuation and to more broadly clarify its purpose.[3]

On reflection, it appears that the way in which superannuation has evolved has often been convoluted and disorderly. Nonetheless, it is possible to identify a basic co-dependency relationship for its existence based on taxation concessions and regulatory constraint. The relationship has varied in strength and relevance over time, given that legislative objectives have also changed as superannuation coverage has grown. So, while early constraints are more easily characterised as a simple trade-off for a concessional taxation treatment, the expanding coverage of superannuation in later years reduced the directness of this relationship by escalating the need to assure the safety of member savings.

2.2 "Superannuation" defined

Neither of the primary income tax or regulatory enactments for superannuation actually define the word "superannuation".[4] Accordingly, clarification of its meaning must be sought elsewhere. Many texts and reports do cover the topic of superannuation, though few give detailed consideration to the meaning of the word before moving on to examine the vehicle through which superannuation is structured.[5] Rather than a criticism, this may reflect a reality that taxation and regulatory issues typically arise at the superannuation fund level, calling for guidance on the treatment of superannuation contributions, earnings and benefit payments that pass through the vehicle.

1 During the period between 1936 and 1976 various legislative amendments and consolidations resulted in name changes to the ITAA1936. These name changes have been cited in this thesis as appropriate. After 1976 the legislation reverts back to its name on enactment and is cited as the ITAA1936.

2 See Peter Costello, Treasurer, 'Simplified Superannuation Legislation Introduced into Parliament' (Joint Press Release Treasurer and Minister for Revenue and Assistant Treasurer, No 131, 7 December 2006). The press release describes the changes as "the most significant reforms to the taxation of Australia's superannuation system in its history".

3 See Commonwealth of Australia, *Budget 2016-17, Budget Measures, Budget Paper No.2* (2016) 24-30.

4 The term is absent from the general definitions contained in the ITAA1936 s 6(1), *Income Tax Assessment Act 1997* (Cth) s 995-1 and *Superannuation Industry (Supervision) Act 1993* (Cth) s 10.

5 For example, Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) 6.

Historically, superannuation has been associated with employment, carrying the meaning of retirement from service by reason of advancing age, with the granting of a pension as an ancillary, although not necessarily implied feature.[6] However, changes in commercial and regulatory practices mean that this description has become less capable of modern day application. In particular, superannuation is accessible, not only by people engaged under contracts of service but also to the increasing number of self-employed persons in society.[7] The basis for gaining access to superannuation has also arguably shifted its focus away from age towards retirement or transition to retirement, accommodating the personal choice of an individual to work longer or allowing conditional earlier access to benefit payments.

Despite these developments, many approaches continue to explain the meaning of superannuation by reference to the employment relationship, preoccupied with its historic origins rather than embracing an expanded modern role. On that basis, the term superannuation might be defined as a method of investment or saving that provides financial support for employees or their dependants, the benefit of which may be realised on the employees' cessation of employment, retirement or death.[8] Other definitions have focussed on the action of superannuating an employee or a pension paid to a retired person.[9] Neither approach is particularly instructive or useful for contemporary application.

With some exception, case law does not indulge in broad-ranging consideration of superannuation before examining the circumstances of the parties it is tasked to adjudicate. However, the meaning of the word superannuation did receive some attention from Bryson J in *Meulman & Ors v OTC Ltd*:[10]

> Although the connotation is extremely wide, it is my view of the ordinary meaning of the word "superannuation" and related words, that benefits are provided for the purpose of enabling or assisting an employee or office holder to give up work and retire from economic activity if he wishes to, on reaching an age where it is appropriate to do so or on reaching a state of health in which it is appropriate to do so. The meaning does not necessarily involve

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6 Fred Richards, *Taxation Aspects of Superannuation in Australia* (Rydge Publications Pty Ltd, 1971) 6.

7 Superannuation contributions in relation to the self-employed may be mandatory for SG purposes, given the expanded statutory definition of employee which includes contracts wholly or principally for labour. See *Superannuation Guarantee (Administration) Act 1992* (Cth) s 12(3).

8 Ray Finkelstein and David Hamer (eds), *LexisNexis Australian Legal Dictionary* (LexisNexis, 2nd ed, 2016) 1503.

9 Lesley Brown (ed), *Shorter Oxford English Dictionary on Historical Principles* (Oxford University Press, 5th ed, 2002) vol 2, 3112.

10 *Meulman & Ors v OTC Ltd* (1990) 96 ALR 223, 237.

> any idea that there is compulsion to give up economic activity; in ordinary usage people collect their superannuation pensions but enter into fresh employment when they wish to do so; but they have reached an age or state of health where a choice not to do so is appropriate. A contractual provision or scheme or a payment of a lump sum or annuity on giving up employment while in good health would not fall within the ordinary meaning of "superannuation" unless the employee or office holder had reached an age where that was appropriate; what that age is would depend on the nature of the occupation but it is rarely under 50 years of age and is sometimes much older.

Bryson J's comments focus on benefits provided not only to an employee but also to an office-holder, demonstrating some willingness to go beyond the employment relationship. The view is expressed that superannuation would exclude benefits provided to a person in good health that had not reached an age at which it would be appropriate to give up employment.[11] The intention here appears to highlight the demarcation between superannuation and a payment that is now described as an employment termination payment (ETP). Strictly, while the age (and period of employment) of an individual may affect the taxation rates applicable to an ETP, under current taxation arrangements age is not determinative of a payment to become superannuation, assuming the appropriate age of retirement can be identified.[12] Other legislative developments, such as transition to retirement superannuation pensions, add further complexity by encouraging persons to remain in the workforce while also giving them limited access to superannuation.[13]

In approaching the word superannuation, a balance must be maintained between being too prescriptive, placing over-reliance on some aspects to the exclusion of others, and being so general as to limit any meaningful application. The various attempts have difficulty in avoiding at least some criticism on one of these bases and suggest that construction of a widely accepted definition is difficult. Given the particular focus of this thesis on the self-managed superannuation fund (SMSF), it is sufficient, for the purposes of broad context, to adopt a working description based on ordinary commercial usage. On that basis, the word "superannuation" can be adequately described as a benefit or benefits provided to a person (or his/her dependants) upon retirement from office, employment or self-employment, upon reaching a prescribed age, meeting a condition of release or death.

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[11] These payments would be characterised as a golden handshake and regarded as an employment benefit rather than superannuation.
[12] The requirements of an ETP are prescribed in *Income Tax Assessment Act 1997* (Cth) s 82-130.
[13] *Income Tax Assessment Act 1997* (Cth) s 82-135(a) provides that a payment is not an ETP if it is a superannuation benefit.

2.3 "Superannuation fund" defined

Taxation and regulatory approaches

Beyond difficulties with the word superannuation, the legislature has variously defined and redefined the phrase "superannuation fund". A historical consideration of these approaches reveals, that beyond its trust legal framework, a growing importance of statute to prescribe its features and devise sub-categories with the necessary attributes to access to a concessional taxation treatment. This statutory evolution began with early attempts in Commonwealth taxation legislation, given the then central role that taxation played in both revenue collection and regulating superannuation fund activity. This occurred quite some time after the Government's first involvement in these activities through the *Income Tax Assessment Act 1915* (Cth) (ITAA1915), appearing in the *Income Tax and Social Services Contribution Assessment Act 1936-1961* (Cth) (ITSSCA1936-1961). In particular, a superannuation fund was defined to mean "a provident, benefit, superannuation or retirement fund the income of which would, but for this Division, be exempt from income tax by virtue of paragraph (j) or (ja) of section twenty three of this Act…[but excluded all other types of funds]".[14]

The purpose of this early definition was to capture certain superannuation funds established for the benefit of employees or approved funds for non-employees that would be exempt from income taxation.[15] The income tax exemption for these superannuation funds was then made conditional upon satisfying further restrictions contained in a new Division 9B of Part III of the ITSSCA1936-1961.[16] Critically, this required holding a portion of assets under management in Commonwealth and public securities, known as the "30%-20% ratio of public securities".[17] The practical effect of the definition and security holding requirement

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14 ITSSCA1936-1961 s 121B, inserted by the *Income Tax and Social Services Contribution Assessment Act 1961* (Cth).

15 Namely, those superannuation funds that were exempt from income taxation under ITSSCA1936-1961 ss 23(j), 23(ja). In relation to the former, ITSSCA1936-1961 s 23(j) covered three types of superannuation fund, with the most relevant for this thesis being those coming within ITAA 1936-1961 s 23(j), 23(i). ITSSCA1936-1961 s 23(j)(i) provided an exemption from income tax for a provident, benefit or superannuation fund established for the benefit of employees. ITSSCA1936-1961 s 23(ja) provided an exemption from income tax for a provident, benefit, superannuation or retirement fund (not being established for the benefit of employees), provided that its membership was not less than twenty persons and the terms and conditions of the fund had been approved by the Commissioner of Taxation.

16 ITSSCA1936-1961 Pt III 9B, inserted by *Income Tax and Social Services Contribution Assessment Act 1961* (Cth).

17 ITSSCA1936-1961 Pt III Div 9B required that for a s 23(j)(i) or s 23(ja) superannuation fund to be exempt from income tax it needed to hold public securities amounting to not less than 30% of its total assets (including Commonwealth securities amounting to not less than 20% of total assets).

was to impose restrictions that would otherwise be unlikely features for a superannuation fund to possess.

However, deferring the requirement to hold public securities for later discussion, the superannuation fund definitional elements in s 121B of the ITSSCA1936-1961 were "provident, benefit, superannuation or retirement fund". That expression aligned with the requirements for taxation exemption contained in s 23(j)(i) and s 23(ja) of the ITSSCA1936-1961, namely a "provident, benefit or superannuation fund established for the benefit of employees" and a "provident, benefit, superannuation or retirement fund established for the benefit of self-employed persons". Neither exemption offered further definition of these words, though the breadth of each was clearly wide. This suggests difficulty in identifying any single essential attribute of a superannuation fund and leaving its meaning to be determined by ordinary usage.[18]

The statutory prescription surrounding the attributes of an income tax exempt superannuation fund established for the benefit of employees increased further upon insertion of s 23F of the *Income Tax and Social Services Contribution Assessment Act 1936-1964* (Cth) (ITSSCA1936-1964).[19] However, consistent with the earlier taxation approach the adopted definition of a superannuation fund for this purpose remained broad, meaning a "provident, benefit, superannuation or retirement fund".[20] The further detailed attributes that were required to remain exempt from income taxation were contained in later subsections outside of this definition.[21]

A similar approach was adopted for the creation of a new category of superannuation fund under s 79 of the ITSSCA1936-1964,[22] that subject to certain conditions were eligible for a less concessional tax deduction equal to 5% of the cost of their net assets. The definition of a superannuation fund for this purpose commenced broadly to mean "a provident, benefit,

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The Explanatory Memorandum, Income Tax and Social Services Contribution Assessment Bill 1961 (Cth) referred to this requirement as the "30%-20% ratio of public securities".

18 *Scott v FCT (No. 2)* (1966) 40 ALJR 265, 278 (Windeyer J); *Mahoney v FCT* (1967) 41 ALJR 232, 232 (Kitto J).

19 Inserted by *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964* (Cth). The Act consequentially repealed the existing taxation exemption contained in *Income Tax and Social Services Contribution Assessment Act 1936-1963* (Cth) s 23(j)(i).

20 ITSSCA1936-1964 s 23F(1). The *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964* (Cth) inserted the same definition of a superannuation fund at ITSSCA1936-1964 s 121B for the purpose of the 30%-20% ratio of public securities requirement, having continued application to s 23F funds and s 23(ja) funds.

21 ITSSCA1936-1964 s 23F(2)-(10).

22 ITSSCA1936-1964 s 79, inserted by *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964* (Cth).

superannuation or retirement fund”.[23] The definition then excluded certain categories of superannuation fund, including those that were tax exempt under s 23(ja) or s 23F of the ITSSCA1936-1964 so as to avoid overlap. Once again the detailed attributes that were required to access the concessional tax treatment were contained in later subsections outside of this definition.[24] In 1984 s 23FB of the ITAA1936 was inserted to provide an exemption from taxation to superannuation funds that met the requirements of s 79 of the ITAA1936, along with further conditions.[25] The same definitional approach was adopted and followed by detailed restrictions in later subsections.

The enactment of the *Occupational Superannuation Standards Act 1987* (Cth) (OSSA) and the accompanying *Occupational Superannuation Standards Regulations* 1987 (Cth) (OSSR) introduced a slightly different approach. Rather than follow the lead of taxation law,[26] upon enactment the OSSA defined a superannuation fund with further detail to mean:[27]

> a fund that:
> (a) is an indefinitely continuing fund; and
> (b) is maintained solely for either or both of the following purposes:
> (i) the provision of benefits for each member of the fund in the event of the retirement of the member from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
> (ii) the provision of benefits for dependants of each member of the fund in the event of the death of the member;
> or for either or both of those purposes and for such ancillary purposes as the Commissioner approves.

The OSSA definition makes an advance on the expression “provident, benefit, superannuation or retirement fund” that had previously applied in taxation law. However, its content was not completely new and appears to elevate constraints that had previously operated alongside the earlier tax law definitions.[28] Accordingly, as a definitional requirement, a superannuation fund needed to be an indefinitely continuing fund and one

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23 ITSSCA1936-1964 s 79(1).
24 ITSSCA1936-1964 s 79(2)-(10).
25 ITAA1936 s 23FB, inserted by *Income Tax Assessment Amendment Act (No 3) 1984* (Cth).
26 That is, defining a superannuation fund as a “provident, benefit, superannuation or retirement fund”.
27 OSSA s 3(1) (definition of “superannuation fund”).
28 For example; ITSSCA1936-1964 s 23F(2)(a) required a superannuation fund to be an “indefinitely continuing” fund and “maintained solely” for the purpose of providing benefits upon retirement or death of employees.

that was maintained solely for either or both of certain restricted purposes concerning the provision of benefits upon retirement or death. The definition also specifically identified scope to pursue non-defined ancillary purposes that are to be approved by the Commissioner of Taxation (FCT). Yet, despite containing increased detail, the definition continued to be supplemented with further constraints contained elsewhere in the OSSA to limit access to a concessional taxation treatment.

To accommodate the introduction of the OSSA, the role of the superannuation fund definitions in the ITAA1936 became substantially functional. Accordingly, s 6(1) of the ITAA1936 defined a superannuation fund to include "a superannuation fund within the meaning of the OSSA" and "a fund to which s 23FC applies in relation to the year of income concerned".[29] The taxation exemptions (and their references to a provident, benefit, superannuation or retirement fund) in s 23F and s 23FB of the ITAA1936 were replaced by s 23FC of the ITAA1936.[30] The role of the latter was to connect the OSSA with the task of making qualifying superannuation funds exempt from income tax. A superannuation fund would obtain income tax exemption, conditional upon receiving notification of compliance with the OSSA and OSSR standards.[31]

In 1990 the OSSA definition of a superannuation fund was amended to include age as a criterion in providing benefits to a member. Accordingly, the first eligible purpose of a superannuation fund was amended to include the payment of benefits at an age prescribed in regulations even where the member had not retired.[32] The second eligible purpose of a superannuation fund was also amended to include benefits in the event of death of the member, occurring before retirement or reaching an age prescribed in regulations.[33] Soon after this time a third eligible purpose was added to provide retired members with the capacity to transfer their pensions between different funds.[34] Accumulating these changes,

29 ITAA1936 s 6(1) (definition of "superannuation fund") inserted by *Taxation Laws Amendment Act (No 4) 1987* (Cth).

30 ss 23F and 23(ja) repealed by *Taxation Laws Amendment Act (No 4) 1987* (Cth); s 23FC inserted by *Taxation Laws Amendment Act (No 4) 1987* (Cth).

31 OSSA s 5(1). The OSSR initially referred to the earlier taxation law exemption restrictions until its own standards were devised.

32 OSSA s 3(b)(ii) (definition of "superannuation fund"), inserted by *Occupational Superannuation (Reasonable Benefit Limits) Amendment Act 1990* (Cth).

33 OSSA s 3(b)(iii) (definition of "superannuation fund"), inserted by *Occupational Superannuation (Reasonable Benefit Limits) Amendment Act 1990* (Cth).

34 OSSA s 3(b)(iv) (definition of "superannuation fund"), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

the OSSA definition of a superannuation fund had expanded to mean:[35]

> a fund that:
>
> (a) is an indefinitely continuing fund; and
>
> (b) is maintained solely for one or more of the following purposes:
>
> (i) the provision of benefits for each member of the fund in the event of the retirement of the member from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
>
> (ii) the provision of benefits for each member of the fund in the event of the member attaining a particular age (being an age not less than the age prescribed by the regulations) without having retired from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
>
> (iii) the provision of benefits for dependants of each member of the fund in the event of the death of the member, being a death occurring before:
>
> (A) the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged; or
>
> (B) the member attains a particular age (being an age not less than the age prescribed for the purposes of subparagraph (ii)) without having retired from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged; whichever is earlier;
>
> (iv) the provision of pensions for each transferred retiree member of the fund;
>
> or for one or more of those purposes and for such ancillary purposes as the Commissioner approves.

The enactment of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) in 1993 brought further change to the definition of a superannuation fund with the adoption of a much less prescriptive approach. This did not signify a relaxation of the purposes for which a superannuation fund seeking income tax exemption could be conducted, but a reversion to the earlier taxation law approach as to how this was achieved. Accordingly, a superannuation fund was defined using broad descriptive language, but subject to further detailed restriction outside the definition. An increase in the range of constraint embodied in the SISA more than

35 OSSA s 3(1) (definition of "superannuation fund"), consolidating amendments in *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

counterbalanced the reduced definitional prescription and continued to yield quite a specific type of vehicle. The SISA definition of a superannuation fund has remained without amendment since enactment to mean:[36]

> (a) a fund that:
>
> > (i) is an indefinitely continuing fund; and
> >
> > (ii) is a provident, benefit, superannuation or retirement fund; or
>
> (b) a public sector superannuation scheme.

Consideration of the regulatory meaning

Given the ultimate focus of this thesis on the SMSF, it is appropriate to narrow the analysis to private superannuation funds constituted by trust, which are covered by the first limb of the SISA definition.[37] Accordingly, the preliminary requirement is that there must be a fund. A fund can ordinarily be described as meaning money (or investments) set aside and invested, the surplus income therefrom being capitalized.[38] However, historically the ordinary meaning of a fund has been refined by a further requirement that the type of arrangement must also be bona fide devoted to its sole purpose. Thus, although a fund might exist in the general sense, it would be ineligible to qualify as superannuation fund if, despite the requisite purpose expressed in its deed, the parties did not intend that such purpose should take effect.[39]

The next requirement to be an "indefinitely continuing fund" is consistent with the historic OSSA and taxation law definitions of a superannuation fund.[40] The expression is not defined further in the SISA, however there is some clarification that if the governing rules of a superannuation fund contain a provision to avoid a breach of the rule against perpetuities, then that provision does not prevent the fund from being treated as indefinitely continuing.[41] While the ordinary meaning of "indefinitely" suggests an unlimited or indeterminate period,[42]

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36 SISA s 10(1) (definition of "superannuation fund").

37 A public sector superannuation scheme is created under an Act to provide superannuation and products to eligible government employees and participating employers. The legal characteristics of such schemes are considered in *Superannuation Fund Investment Trust v Commissioner of Stamps (SA)* (1979) 145 CLR 330, with divergent views expressed on the effect of a scheme for Commonwealth employees established under the *Superannuation Act 1976* (Cth).

38 *Scott v FCT (No 2)* (1966) 40 ALJR 265, 278 (Windeyer J).

39 *Scott v FCT (No 2)* (1966) 40 ALJR 265, 279 (Windeyer J).

40 Refer ITAA1936 ss 23F, 23FB; OSSA s 3(1).

41 SISA s14.

42 Lesley Brown (ed), *Shorter Oxford English Dictionary on Historical Principles* (Clarendon Press, 5th ed, 2002), vol 2.

it has been doubted whether in its context the word could mean "forever".[43] That view is consistent with the expectation that superannuation funds would have some mechanism to facilitate being wound up.

The final requirement is that the fund is a "provident, benefit, superannuation or retirement fund" which is once again consistent with historic taxation law definitions of a superannuation fund.[44] The expression omits any reference to a "maintained solely" requirement present in the OSSA definition,[45] however that attribute remains highly relevant for the more narrowly defined regulated superannuation fund.[46] The expression "provident, benefit, superannuation or retirement fund" is not defined further in the SISA and therefore its meaning requires an examination of the ordinary meaning of those words. A limited number of cases have embarked on this task,[47] with the dominant theme that a succinct explanation remains elusive.

Some clarification of words "provident, benefit or superannuation fund" is provided by Kitto J in *Mahony v FCT* in the context of paragraph 23(j)(i) of the *Income Tax and Social Services Contribution Assessment Act 1936-1958*:[48]

> Since a fund, if its income was to be exempt under the provision, was separately required to be one established for the benefit of employees, each of the three descriptive words "provident", "benefit" and "superannuation" must be taken to have connoted a purpose narrower than the purpose of conferring benefit, in a completely general sense, upon employees….All that need be recognized is that just as "provident" and "superannuation" both referred to the provision of a particular kind of benefit – in the one case a provision against contemplated contingencies, and in the other case a provision, to arise on an employee's retirement or death or other cessation of employment…– so "benefit" must have meant a benefit, not in the general sense, but characterized by some specific future purpose.

In *Scott v FCT (No.2)* Windeyer J considered the same paragraph, though dissected the expression to focus more on the words "superannuation fund" established for the benefit of an

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43 *Cameron Brae Pty Ltd v FCT* (2007) 161 FCR 468, [108] (Jessup J).
44 Refer ITAA1936 ss 23F, 23FB.
45 OSSA s 3(1) (definition of "superannuation fund"), consolidating amendments in *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).
46 Refer SISA ss 19, 62.
47 *Scott v FCT (No.2)* (1966) 40 ALJR 265, 278 (Windeyer J); *Mahony v FCT* (1967) 41 ALJR 232, 232 (Kitto J); *Walstern v FCT* (2003) FCR 1, 15 (Hill J); *Cameron Brae Pty Ltd v FCT* (2007) 161 FCR 468, [102] (Jessup J).
48 *Mahony v FCT* (1967) 41 ALJR 232, 232.

employee:[49]

> … I have come to the conclusion that there is no essential single attribute of a superannuation fund established for the benefit of employees except that it must be a fund *bona fide* devoted as its sole purpose to providing for employees who are participants money benefits (or benefits having a monetary value) upon their reaching a prescribed age.

The issue arose more recently in the context of the definition of superannuation fund in the ITAA1936,[50] the second limb of which adopts the SISA meaning. After taking into account both of the above passages, Jessup J in *Cameron Brae Pty Ltd v FCT* concluded:[51]

> Thus, as a matter of common understanding, it would seem that a superannuation fund is a fund which has as its sole purpose the provision of benefits to participating employees upon their reaching a prescribed age (per Windeyer J) or upon their retirement, death or other cessation of employment (per Kitto J).

The observation reiterates an approach to the phrase "superannuation fund" as a matter of ordinary usage. It also contains some deficiencies for general application. Although the context did not require elaboration, a superannuation fund may clearly extend to self-employed persons as well as the employed. The explanation is also descriptive rather than prescriptive in nature, which is not surprising given that a superannuation fund is a type of trust, a vehicle whose definition also tends to be descriptive. However, what is clear is that a superannuation fund must exclusively provide a narrow range of benefits that are characterised by some particular future purpose.[52] The SISA provides the necessary guidance as to what benefit and specific purpose a superannuation fund should provide through regulatory settings that provide access to a concessional tax treatment.[53] At a detailed level, this outcome rests on being able to demonstrate the required characteristics of various superannuation fund sub-species.

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[49] (1966) 40 ALJR 265, 278.

[50] ITAA1936 s 6(1) (definition of "superannuation fund") substituted by *Taxation Laws Amendment Act (No. 4) 1994* (Cth). A superannuation fund is defined to mean (a) a scheme for the payment of superannuation benefits upon retirement or death; or (b) a superannuation fund within the definition of "superannuation fund" in section 10 of the *Superannuation Industry (Supervision) Act 1993* (Cth). The second limb of the definition is most relevant for private superannuation funds constituted by trust.

[51] *Cameron Brae Pty Ltd v FCT* (2007) 161 FCR 468, [102]. The majority (Stone and Allsop JJ) did not ultimately agree with the decision of Jessup J, but did agree that the fund was a superannuation fund for the purposes of ITAA1936 s 82AAE.

[52] *Cameron Brae Pty Ltd v FCT* (2007) 161 FCR 468, [34] (Stone and Allsop JJ).

[53] Refer SISA s 62.

Sub-species of superannuation fund for concessional taxation

When addressing regulatory and connected taxation arrangements for superannuation, it is important to acquire an understanding of what a superannuation fund entails for both of those purposes. Accordingly, the preceding analysis provides important general guidance. However, the significance of the expression "superannuation fund" may to some extent be overshadowed by the SISA's adoption of more refined legislative terms, narrowing to yield a specific type of superannuation fund that is eligible for a concessional taxation treatment. Essentially, a superannuation fund will need to qualify as a "complying superannuation fund".[54] This occurs where a superannuation fund has received notice from the Regulator[55] that it is a complying superannuation fund and has not subsequently received notice that it is not a complying superannuation fund.[56] Attainment of complying status is critical given that tax concessions provide the incentive for superannuation funds to exist and accept regulatory constraint under the co-dependency relationship.

The SISA eligibility requirements for a complying superannuation fund differ depending on whether the fund is a SMSF or another type of fund.[57] In many instances the SISA imposes less onerous regulatory obligations on SMSF trustees in comparison to other trustees. The characteristics of an SMSF are addressed in Chapter 3, though broadly they are superannuation funds with less than five members, each member being a trustee or trustee-director and the trustee receiving no remuneration from the fund.[58] A range of superannuation funds do not typically meet these requirements, including: corporate funds established by employers to benefit their employees, retail funds made available to the public on a commercial basis, industry funds historically established for members of particular industries though now accepting contributions from the public, and personal superannuation funds established by a member described as small Australian Prudential Regulation Authority (APRA) funds.

Focussing on the basic case of a superannuation fund that has been an SMSF at all times during an income year, the requirements to qualify as a complying superannuation fund in relation to that income year are that the entity:

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[54] SISA ss 42, 42A, 45.

[55] For this purpose, the Regulator is either the Australian Taxation Office or the Australian Prudential Regulation Authority. The former is narrowly responsible for administration of SMSFs. Refer SISA s10(1) (definition of "Regulator").

[56] SISA s 40.

[57] SISA ss 42, 42A.

[58] SISA ss 17A, 17B.

- was a resident regulated superannuation fund at all times during the year of income when the entity was in existence;[59] and
- passes the compliance test.[60]

These restrictions effect a substantial narrowing from the SISA definition of a superannuation fund and its reliance on the ordinary usage of those words. Beyond the particular attributes of an SMSF, the first condition is that the entity is a "resident regulated superannuation fund". This is a statutory expression that is determined according to the SISA and taxation law criteria. The second condition of passing the compliance test subjects the entity to a suite of further statutory restrictions in the SISA. Together, these requirements for a complying superannuation fund produce a very unique statutory product. While the basic foundations are those of a superannuation fund, whose meaning is identified through common usage, the extent of further statutory intervention is transformative.

To substantiate this outcome and the degree of legislative prescription, the elements of a complying superannuation fund are examined in further detail. The expression "resident regulated superannuation fund" is defined in the SISA to mean a "regulated superannuation fund" that is an "Australian superannuation fund" within the meaning of the ITAA1997.[61] The SISA defines a "regulated superannuation fund" to be a superannuation fund that complies with the following:

- The fund has a trustee.[62]
- Either:
    - The trustee of the fund is a constitutional corporation pursuant to the requirements of the fund's governing rules; or
    - The governing rules of the fund provide that the sole or primary purpose of the fund is the provision of old age pensions.[63]
- The trustee or trustees of the fund have given the Regulator a written notice in the approved form that is signed by all trustees stating that the SISA is to apply to the fund.[64]

59 SISA s 42A(1)(a)(i).
60 SISA s 42A(1)(b).
61 SISA s 10(1) (definition of "resident regulated superannuation fund").
62 SISA s 19(2).
63 SISA s 19(3).
64 SISA s 19(4).

The first requirement of a regulated superannuation fund confirms that the entity must have a trustee and therefore be constituted by trust. The second requirement reflects the legislative basis of the SISA, with its existence relying on the Government's constitutional powers in respect of old age pensions and corporations.[65] The third requirement necessitates trustees to advise the Regulator that they agree to be subject to the SISA regime. The voluntary decision to submit to the SISA regulatory framework reflects the second limb of the SMSF co-dependency relationship that access to a concessional taxation treatment is necessarily subject to restrictions.

Beyond the SISA restrictions on a regulated superannuation fund activity, there are further statutory limits surrounding the eligibility for tax concessional treatment by reference to the superannuation fund's connection to Australia. The scope for eligibility has narrowed over time and now requires the existence of an Australian superannuation fund. The *Income Tax Assessment Act 1997* (Cth) (ITAA1997) provides that a superannuation fund is an "Australian superannuation fund" at a time, and for the income year in which that time occurs, if:

- the fund was established in Australia, or any asset of the fund is situated in Australia at that time;[66] and
- at that time, the central management and control of the fund is ordinarily in Australia;[67] and
- at that time, either the fund had no active member, or active members who are Australian residents holding at least 50% of either of the following:
    - the total market value of the fund's assets attributable to superannuation interests held by active members, or
    - the sum of the amounts that would be payable to or in respect of active members if they voluntarily ceased to be members.[68]

The first of these requirements is relatively straightforward. However, the location of central management and control (CMC) for the purpose of the second requirement is more difficult, with labour force mobility and personal choice not uncommonly leading to trustee-members residing outside Australia. Some statutory assistance is provided, in that CMC of a superannuation fund is ordinarily in Australia at a time, even if that central management and

[65] *Commonwealth of Australia Constitution Act 1900* (Cth) ss 51(xxiii), (xx).
[66] ITAA1997 s 295-95(2)(a).
[67] ITAA1997 s 295-95(2)(b).
[68] ITAA1997 s 295-95(2)(c).

control is temporarily outside Australia for a period of not more than two years.[69] The third requirement is for active members with particular holding characteristics. A member will be an active member at a particular time if they are a contributor to the fund at that time.[70] A member will also be an active member if they are an individual on whose behalf contributions have been made, unless the individual is a foreign resident, not a contributor at that time and for whom contributions made on the individuals' behalf after becoming a foreign resident are only payments made in respect of the time when they were an Australian resident.[71] The potential complexity in establishing the existence of an Australian superannuation fund is reflected by the issuance of in-depth guidance by the Australian Taxation Office (ATO) to assist SMSF trustees.[72]

Beyond these conditions, the final requirement is to satisfy the compliance test. This will be achieved where the superannuation fund did not contravene the SISA during the year of income.[73] To this end, the SISA encapsulates a broad range of matters to be addressed, such as the trustee covenants, investment strategies, contribution standards, portability standards, preservation standards, the sole purpose test, investment restrictions and in-house asset rules. The detail of these requirements is considered later in this chapter, sufficed to say that they impose significant constraint on trustee behaviour. Where contravention of these requirements does occur, it is still possible to satisfy the compliance test where the FCT considers that the taxation consequences of treating the SMSF as non-complying outweigh the seriousness of the breach.[74]

Although the focus of this thesis is the SMSF, the legislative constraints to achieve complying status for superannuation funds that are not SMSFs are broadly similar.[75] However, apart from having APRA as their principal regulator, an important difference for non-SMSF superannuation funds is that they must satisfy a "culpability test" rather than the compliance test.[76] The culpability test will be failed in two situations: where either all fund members were knowingly concerned in the contravention or at least one member was knowingly concerned; and innocent members would not suffer substantial detriment if the superannuation fund were

69 ITAA1997 s 292-95(4).
70 ITAA1997 s 292-95(3)(a).
71 ITAA1997 s 292-95(3)(b).
72 Australian Taxation Office, Taxation Ruling TR 2008/9 Income tax: meaning of 'Australian superannuation fund' in subsection 295-95(2) of the *Income Tax Assessment Act 1997* (2008).
73 SISA s 42A(5)(a).
74 SISA s 42A(5)(b).
75 SISA s 42.
76 SISA s 42(1)(b)(ii). The culpability test will be relevant to a superannuation fund that has been a SMSF for only part of the income year. Refer SISA ss 42A(2)(b)(ii), (3)(g), (4)(f)(ii).

treated as non-complying.[77] In both instances the Regulator must, after taking into account the seriousness of the contravention, the tax consequences of non-complying status and other relevant matters, determine that a notice should be given stating that the superannuation fund is not complying.[78] The range of constraints and scope for contravention of the SISA is enlarged for a non-SMSF superannuation fund, given that the regulatory exceptions in the SISA that are specific to the SMSF have no application. Once again, assuming that the culpability test is satisfied, the outcome is a vehicle with very particular statutory attributes.

Conclusion – statutory definitional approaches

The difficulty in producing a concise definition of the word "superannuation" has been identified and shown to continue when addressing the meaning of the expression "superannuation fund". Yet, it is critical to understand these subjects so as to ensure that the subsequent analysis in this thesis builds from a proper foundation. Historical approaches provide useful guidance on these matters; though have also slowly changed in response to modern working arrangements less reliant on employment relationships and evolving tax and regulatory regimes. The latter considerations are particularly important, given that superannuation funds responsible for holding superannuation savings typically seek the advantage of a tax concessional treatment.

Taxation law initially undertook a dual revenue and regulatory role for superannuation and provides significant guidance on the definitional approaches to the expression superannuation fund. This guidance arose in the course of specifying the conditions under which such a vehicle would be eligible for an exemption from income taxation or other less concessional taxation treatment. Typically, a broad definition was adopted, with the meaning of the words used being dependent on their ordinary usage. The introduction of separate prudential regulation saw some further legislative detail added, which appeared consistent with the non-definitional constraints that had operated alongside the earlier taxation law definitions. Ultimately, prudential law reverted to the earlier taxation approach of a broad definition, being an indefinitely continuing provident, benefit, superannuation or retirement fund.

Deceptively, the meaning of the expression superannuation fund does not explain the particular legislative features that such an entity must possess in order to qualify for a concessional taxation treatment. This is achieved by the creation of narrow statutory categories of superannuation fund, each with particular requirements to be satisfied. The

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77 SISA s 42(1A)(a)(i), (b)(i)-(iii).
78 SISA s 42(1A)(a)(ii), (b)(iv).

ultimate objective is to meet the SISA requirements of "complying superannuation fund". Attaining this status is dependent on satisfying the further SISA definition of "resident regulated superannuation fund" and the ITAA1997 definition of an "Australian superannuation fund". Collectively these definitions yield a very specific type of vehicle, whose characteristics are overwhelmingly impressed through statutory intervention. That conclusion provides some initial support to further enquire whether the role of statute for superannuation funds should be extended, vis-à-vis their continued reliance on the trust structure.

2.4 The history of superannuation in Australia

2.4.1 A component of a retirement income system

The development of superannuation in Australia reflects a slow progression, evolving from unstructured and isolated beginnings to a sophisticated element of a comprehensive retirement income system. This historical change was driven by the actions of private employers, individual self-interest and government intervention to give access to a retirement income once participation in the workforce had ceased. While initially the preserve of a privileged minority for whom its concessional taxation treatment would have been particularly attractive, the usefulness of superannuation was later adopted by the broader populace to facilitate their retirement objectives.

The expanding coverage of superannuation influenced the content of its taxation and regulatory settings. When superannuation was initially utilised by a small number of privileged individuals, the constraints suitably focussed on taxation aspects. Participants were likely to have been well resourced, more capable of looking after their own interests and potentially subject to high marginal rates of personal income taxation. In contrast, as superannuation became more accessible and later compulsory it followed that the financial position, skills and motivations of a broad membership diversified. These changing circumstances required regulation to protect superannuation interests and ensure that savings were properly applied for members' retirement.

Complementing the role of superannuation and together forming two significant parts of the retirement income system, it is also important to address the role of the old age pension for retirement incomes. Its importance is reflected in the fact that the old age pension continues to be described as the centre piece of the system.[79] This source of retirement income is critical for those individuals whose work history has supported no or only limited contributions to superannuation and do not have other sources of voluntary private savings. For other individuals, voluntary private savings do in fact provide an important source of retirement income and as such have been recognised as the third pillar of the retirement income system.

Understanding how superannuation has evolved over time provides important context to how and why the present arrangements are in place. The main historical driver has been the expanding coverage achieved by superannuation funds established for the benefit of employees, their growing importance to members and the financial system attracting Government enquiries and legislative reform. The foregoing analysis divides superannuation into four periods, the first three of which have been identified in earlier literature as eras of occupational superannuation: the nineteenth century to the 1940s, the 1950s to the 1970s and the 1980s to the 1990s.[80] A fourth period captures developments to the present time. This background is then a foundation for a similar historical analysis of the tax and regulatory settings for superannuation. Ultimately, superannuation has grown to become a product of compulsory and voluntary participation, both encouraged and restricted through ongoing Government intervention.

First phase: nineteenth century to the 1940s

Prior to the creation of formal mechanisms to save for retirement or a semblance of a systematic approach, the earliest forms of retirement benefits in Australia were made ex-gratia and typically met by an employer out of current revenue.[81] In many instances, early benefits were likely to have held more of a sentimental than monetary value, such as a pendant or watch. Accordingly, the responsibility for making whatever provision that was necessary for retirement fell squarely to the individual through accumulation of voluntary private saving or family support. Assistance from government was limited due to finite resources and more pressing needs of the Colonies, such as establishing basic infrastructure, services and institutions for an orderly society.

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[79] Brian Howe, Minister for Social Security, 'Better Incomes: Retirement Income Policy into the Next Century' (1989) iii.

[80] Treasury of Australia, 'Towards higher retirement incomes for Australians: a history of the Australian retirement income system since Federation' (Economic Round up Centenary Edition, 2001) 74.

[81] The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (Paper presented at Superannuation in Australia, NSW,1966) 5.

Although employers subsequently moved to provide retirement benefits of greater monetary value to their employees, initially the recipients were narrowly selected employees that were typically male, highly educated and in senior level positions.[82] Even for these fortunate few, where benefits were funded from current revenue the quantum of payment would potentially reduce if an employee happened to retire during a period of poor profitability or was joined with many other employees retiring in the same financial year. This outcome failed to draw a proper nexus to the contribution made by employees during their earlier years, which may have enabled generous benefits to be paid to past retiring employees.[83]

To reduce the reliance on current revenue, some employers began to make provision for their employees' retirement over a longer time horizon. This planning led to the introduction of privately created superannuation funds for employees, leading the field of retirement income support ahead of public sector schemes and the old age pension.[84] The provision of retirement benefits in this manner dates at least as early as 1842, with a fund offered by the Bank of Australasia.[85] Further superannuation funds slowly emerged after this time, including a fund offered by the Bank of New South Wales in 1862, which on occasion has also been identified as the first occupational superannuation fund.[86] While these schemes reduced the earlier uncertainties they continued to address a very narrow section of the community.

For those individuals who were excluded from these arrangements, the position remained that they should provide their own support in retirement. Some exceptions arose through schemes to cater for retired public servants, though again arrangements were very narrowly focussed.[87] Where the circumstances were such that an individual had no voluntary private savings or family support the fall-back welfare provision was basic and dominated by charitable organisations, motivated by a desire to alleviate only the worst levels of poverty.[88] However, as Australia's population demographic moved to include an increasing number of aged

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82 John McCallum, 'Noncontributory Pensions for Developing Countries: Rehabilitating an Old Idea' (Working Paper No 10, National Centre for Epidemiology and Population Health, The Australian National University, 1989) 13.

83 The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (Paper presented at Superannuation in Australia, NSW,1966) 5.

84 The first colonial scheme commenced with the 1854 South Australian civil servant scheme. Refer David Knox 'Occupational Superannuation in Australia: Present and Future' in Ronald Mendelsohn (ed), *Finance of Old Age* (Centre for Research on Federal Financial Relations, The Australian National University, 1986) 35.

85 John McCallum, 'The Three Historic Phases of Australian Superannuation' (1991) 142 *Superfunds* 36.

86 Senate Select Committee on Superannuation, Parliament of the Commonwealth of Australia, *Safeguarding Super* (1992) 10 [2.21].

87 Alpheus Todd, *Parliamentary Government in the British Colonies* (Longmans, Green and Co., 2nd ed, 1894) 44-5; The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (Paper presented at Superannuation in Australia, NSW, 1966) 3.

88 Thomas Kewley, *Social Security in Australia 1900-72* (Sydney University Press, 2nd ed, 1973) 15.

persons, combined with the effects of an economic depression during the 1890s, the case for limited government involvement came under strain.[89]

A shift in attitudes emerged surrounding the extent to which individuals were expected to provide for themselves in retirement and led to the endorsement of a principle that the public carried some collective responsibility to provide a basic level of welfare for its citizens in retirement.[90] The change in approach was first implemented in 1900 by the Colony of New South Wales,[91] adopting a non-contributory means tested old age pension scheme closely following New Zealand age pension legislation introduced two years earlier.[92] The scheme provided statutory entitlements, rather than offering payments on a discretionary basis, as had many of the early selective welfare measures.[93] The Colonies of Victoria and Queensland subsequently introduced similar schemes.[94]

The power of the Government to enter the field of old age pensions was assured following the passage of the *Commonwealth of Australia Constitution Act 1901* (Cth) (Constitution).[95] Shortly thereafter a Royal Commission on Old-Age Pensions took place, ultimately recommending that a Commonwealth system of old-age pensions be established at an early date.[96] After overcoming certain constitutional hurdles, the Commonwealth non-contributory old age pension scheme[97] was established to be funded from consolidated revenue and to replace the existing State-based schemes.[98] Perhaps due to the fact that the Federation was in its infancy and the manageable size of the ageing population, the public accepted this unfunded approach rather than follow European trends to establish a universal compulsory

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89 John Dixon, *Australia's Policy Towards the Aged: 1890-1972* (Canberra College of Advanced Education, 1977) 161-162.

90 John Dixon, *Australia's Policy Towards the Aged: 1890-1972* (Canberra College of Advanced Education, 1977) 4.

91 *Old-age Pensions Act 1900* (NSW).

92 John McCallum, 'Noncontributory Pensions for Developing Countries: Rehabilitating an Old Idea' (Working Paper No 10, National Centre for Epidemiology and Population Health, The Australian National University December 1989) 8.

93 Social Policy Group, *Social security payments for the aged, people with disabilities and carers 1901 to 2010* (21 February 2011) <http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BN/1011/SSPayments1>.

94 Australian Bureau of Statistics, *Year Book Australia* (1988) Number 71, 379.

95 Constitution s 51(xxxiii) empowered the Commonwealth to legislate for the provision of old age and invalid pensions.

96 Commonwealth of Australia, Royal Commission on Old-Age Pensions, *Report from the Royal Commission on Old-Age Pensions* (1906) ix.

97 The scheme was created by the *Invalid and Old-Age Pensions Act 1908* (Cth).

98 Section 93 of the Constitution required surplus revenue of the Commonwealth Government to be distributed back to the States. The *Surplus Revenue Act 1908* (Cth) enabled this surplus revenue to be kept by the Commonwealth to enable, amongst other things, funding of its old age pension scheme.

funded scheme.[99] Accordingly, the old age pension has remained in place since this time, albeit subject to various reforms which have at times increased and limited access and benefits.

Yet, soon after its introduction concerns arose about the funding arrangements for the old age pension and led successive Governments to investigate the merit of its replacement by comprehensive national insurance.[100] Despite a number of attempts, the introduction of such a scheme did not occur, mainly due to electoral unpopularity, war time and economic factors.[101] This did not halt the demographic of an ageing population that would mean increased reliance on the old age pension funded from consolidated revenue becoming unsustainable. One avenue to mitigate this outcome was to encourage increased self-provision though taxation concessions for superannuation, being careful not to make the poorest sections of the community worse off through compulsion to participate.

The first Government taxation concessions for superannuation were contained in the ITAA1915, well before any statutory definition of a superannuation fund.[102] A concessional taxation treatment was created for superannuation funds established for the benefit of employees and certain forms of benefit payments made to their members.[103] Due to the passage of time and lack of published statistical records, it is difficult to assess the precise effect of this legislative intervention.[104] It is reasonable to suggest a positive influence on participation levels, though the taxation incentive would have addressed a narrow audience.[105] This follows from the fact that a high income tax threshold exempted much of the population from income taxation and applied relatively low marginal rates to many of those that were taxable.[106] The incentive for more individuals to participate in superannuation would have increased upon the broadening of the income tax base during the 1940s.[107] Further interest in

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99 For example, Germany adopted social insurance programs after unification in 1871.

100 Social insurance was proposed by the Cook Government in 1913, the Bruce/Page Government in 1928, the Lyons Government in 1938 and the Whitlam Government in 1973.

101 John Dixon, *Australia's Policy Towards the Aged: 1890-1972* (Canberra College of Advanced Education, 1977) 35-105.

102 Refer section 2.3 of this thesis for discussion of definitional matters.

103 Refer ITAA1915 ss 11(f), 14(f)-(g).

104 The earliest major source of information on superannuation funds is the Bureau of Census and Statistics (now the Australian Bureau of Statistics) which has conducted periodical surveys on matters including superannuation since 1951.

105 Senate Standing Committee on Community Affairs, Parliament of the Commonwealth of Australia, *Income Support for the Retired and the Aged: An Agenda for Reform* (1988) 162.

106 Australian Government Treasury, Economic Roundup Winter 2006, *A brief history of Australia's tax system* (2006) <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

107 This coincided with the Commonwealth Government taking sole responsibility for income taxation in 1942, departing from the previous approach whereby the Commonwealth Government and the States levied income tax.

superannuation is likely to have arisen after World War II, as a means for employers to attract and retain staff during periods of wage control, and in response to changing standards of living, social service benefit changes, taxation reform and the subsequent post-war economic boom.[108]

Second phase: 1950 to the 1970s

The second phase for superannuation addresses the period from the 1950s through to the 1970s and along with subsequent phases is much shorter than the first. The Government's general encouragement of self-reliance in retirement during this period is suggested by changes in 1954 to relax the means test arrangements for the old age pension.[109] Increases to the income threshold and liberalisation of the property test were aimed to provide people with incentives to work and save.[110] While the level of coverage remained low, the changes may have had some influence with membership of private superannuation funds increasing from 267,000 to 556,000 persons during the period 1951 through to 1963.[111] A similar increase occurred in government, semi-government and local government superannuation funds, with an increase from 287,000 to 497,000 members.[112]

For some sections of the community superannuation had become increasingly attractive as the top marginal rate of income taxation reached 75% in the early 1950s.[113] The arbitrage between the personal income tax rates and the income tax exemption for superannuation funds produced a trend, particularly for superannuation funds established for the benefit of employees, that available taxation concessions were being abused.[114] The 1961 Report of the

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108 Senate Standing Committee on Community Affairs, Parliament of the Commonwealth of Australia, *Income Support for the Retired and the Aged: An Agenda for Reform* (1988) 162; The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (1966) 12.

109 Treasury of Australia, 'Towards higher retirement incomes for Australians: a history of the Australian retirement income System since Federation', Economic Round-up Centenary Edition, (2001) 70.

110 Thomas Kewley, *Social Security in Australia 1900-72* (Sydney University Press, 2nd ed, 1973) 293-4.

111 The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (Paper presented at Superannuation in Australia, NSW,1966) 7.

112 The Australian Chartered Accountants' Research Society (N.S.W. Division), 'Superannuation in Australia' (Paper presented at Superannuation in Australia, NSW,1966) 7.

113 Australian Government Treasury, Economic Roundup Winter 2006, *A brief history of Australia's tax system* (2006) <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

114 Commonwealth Committee on Taxation, Parliament of the Commonwealth of Australia, *Report of the Commonwealth Committee on Taxation* (1961) 154.

Commonwealth Committee on Taxation[115] (Ligertwood Report) addressed these matters and provided the following illustrations of abuse:

- That the superannuation benefits of seasonal workers, who on leaving their service forfeited benefits and rights to the fund, were being inequitably relocated to other selected members so as to gain great advantages.[116]
- That some companies were distributing the bulk of their company profits to a superannuation fund shareholder to relieve the company of undistributed profits tax and the superannuation fund then loaning the proceeds back to the company.[117]
- That some private companies were making interest free loans to a superannuation fund so that investment returns would be exempt from income taxation.[118]

These concerns were addressed through legislative amendments, along with reforms having a more tenuous connection to the objectives of superannuation such as those to encourage superannuation funds to help the funding of public works programs.[119] However, the limited scope of these changes continued to suggest that the Government lacked a clear policy interest in superannuation reform the beyond the regulation of taxation abuses.[120]

The taxation incentives for superannuation were re-considered in the 1975 Full Report of the Taxation Review Committee[121] (Asprey Report) as part of an examination of the overall operation of the taxation system. In addressing superannuation funds established for the benefit of employees, the Asprey Report identified that the available income taxation exemption encouraged "the provision of the future needs of employees by themselves and by employers recognising a moral obligation".[122] It identified superannuation as an important form of long term savings, and noted that their exemption from income taxation required assurance that the funds would only provide benefits upon reaching retirement age, ill health

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[115] Commonwealth Committee on Taxation, Parliament of the Commonwealth of Australia, *Report of the Commonwealth Committee on Taxation* (1961).
[116] Commonwealth Committee on Taxation, Parliament of the Commonwealth of Australia, *Report of the Commonwealth Committee on Taxation* (1961) 152.
[117] Commonwealth Committee on Taxation, Parliament of the Commonwealth of Australia, *Report of the Commonwealth Committee on Taxation* (1961) 154-5.
[118] Commonwealth Committee on Taxation, Parliament of the Commonwealth of Australia, *Report of the Commonwealth Committee on Taxation* (1961) 155.
[119] ITSSCA1936-1961 Pt III Div 9B required certain superannuation funds to comply with a 30%-20% ratio of public securities for this purpose.
[120] John McCallum, 'Noncontributory Pensions for Developing Countries: Rehabilitating an Old Idea' (Working Paper No 10, National Centre for Epidemiology and Population Health, The Australian National University, December 1989) 14.
[121] Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975).
[122] Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975) [21.94].

or death.[123] The Asprey Report findings were set out in the form of two views, without indicating any particular preference between them.[124] The first view proceeded on the basis that, apart from correcting anomalies, the basic structure of superannuation and retirement provisions should remain.[125] The second view recommended more fundamental change to regulation and protection of member interests.[126]

By 1974 superannuation had expanded well beyond a small privileged section of the community to cover 38% of all employees.[127] The expansion called for a further consideration of the taxation law regulatory arrangements, going beyond the potential abuse of taxation concessions to evaluate how superannuation schemes were administered. In this regard, the 1977 Final Report of National Superannuation Committee of Inquiry[128] (Hancock Report) revealed a broad range of problems with occupational superannuation in Australia, including:[129]

- The erosion of benefits payable on retirement, death or disablement by partial forfeiture of accrued entitlements on withdrawal from service.
- The non-preservation of vested superannuation benefits.
- The effect of inflation on the real benefits provided by accumulation schemes and the level of contributions required to fund benefit promise schemes.
- The disparity of employer superannuation support between private and public sector schemes.
- The difficulties encountered by a person seeking to convert a lump sum benefit into an income stream.
- The existence of superannuation scheme provisions that discriminated between the sexes.

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123 Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975) [21.96(b)].

124 Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975) [21.59], [21.60], [21.125].

125 Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975) [21.61]-[21.107].

126 Taxation Review Committee, Commonwealth Government of Australia, *Full Report* (1975) [21.108]-[21.124].

127 Australian Bureau of Statistics, 'Trends in superannuation coverage' (2009) 4102.0 *Australian Social Trends* 41. The coverage percentage is inclusive of owner managers of an incorporated enterprise as their main job and includes people with a superannuation account that may not attract contributions as having superannuation coverage.

128 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977).

129 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977) viii-ix.

- The less favourable taxation treatment of superannuation schemes for the self-employed in comparison to those for employees.
- The more favourable taxation treatment of superannuation lump sum benefits in comparison to income stream benefits.

These difficulties were characteristic of a growing sector, though one that remained held back through taxation and regulatory deficiencies. The Hancock Report made various recommendations to address these issues, albeit influenced by the proposed adoption of a national pension scheme[130] and the perspective that occupational superannuation should play a complementary role to such a scheme.[131] The subsequent decision not to adopt a national pension scheme[132] illustrates a divergence of views and continued uncertainty surrounding the precise role for superannuation in retirement incomes. Nonetheless, the Hancock Report made useful suggestions to influence the operation of occupational schemes. These included the creation of a single category of approved superannuation fund, so as to eliminate the present diversity of provisions in the taxation law conferring partial or total exemption from income taxation on investment earnings.[133] It also recommended that compliance with prescribed standards be a condition for favourable treatment under taxation legislation.[134]

The growing importance of superannuation was again highlighted by the 1981 Final Report of the Committee of Inquiry[135] (Campbell Report) which investigated the Australian financial system, including private sector institutions such as superannuation funds. The Campbell Report questioned the departures from tax neutrality enjoyed by superannuation funds, that required complex safeguards to curb misuse and which in turn impeded their operational efficiency and flexibility.[136] The Campbell Report did not see any need to increase the overall level of ongoing Government regulation and supervision of superannuation funds in order to achieve the desired level of protection for members.[137] It recommended that only

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130 Refer National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *A National Superannuation Scheme for Australia* (1976) xi-xv.
131 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977) x.
132 John Howard, Treasurer ‘Statement by the Treasurer the Hon Howard, MP Superannuation’ (Press Release, No 68, 12 July 1979).
133 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977) ix, 53 [4.25].
134 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977) ix.
135 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981).
136 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981) [15.64]-[15.65].
137 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981) [20.104].

contributions to an approved superannuation fund that met minimum prudential requirements should be eligible for a concessional taxation treatment.[138] It also recommended that those minimum requirements should be incorporated into trust deeds, with an auditor certifying compliance each year and the superannuation fund lodging the certificate and annual return to provide the basis for a concessional taxation treatment.[139] It did not agree with views in the Hancock Report[140] that the FCT could reasonably be expected to have concern for prudential, as opposed to revenue, considerations for superannuation, given the emphasis by the Government on the latter objective.[141]

Third phase: 1980 to the 1990s

The third phase for superannuation covers the 1980s through to the 1990s and, although the highest marginal rate of income taxation fell below 50% during this period, the taxation incentive to participate remained substantial.[142] An early influence on Government to embrace a growing role for superannuation came from the 1983 Final Report of the Commonwealth Task Force on Occupational Superannuation[143] (Taskforce Report). The Taskforce Report specifically responded to its direction to address non-revenue matters such as vesting, preservation and portability of interests, the use of annuities and ways to improve prudential standards.[144] It also considered the earlier Hancock and Campbell Reports, proposed a prudential framework to respond to these issues and endorsed measures to make annuities more attractive.[145]

A further influence on the coverage of occupational superannuation was the emergence of award superannuation in 1986.[146] The early driver for this change came from the union

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138 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981) [20.107].

139 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981) [20.107].

140 National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia* (1977) [4.33].

141 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981) [20.99]-[20.100].

142 Australian Government Treasury, Economic Roundup Winter 2006, *A brief history of Australia's tax system* (2006) <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

143 Commonwealth Taskforce, Commonwealth Government of Australia, *Final Report of the Commonwealth Task Force on Occupational Superannuation* (1983).

144 Commonwealth Taskforce, Commonwealth Government of Australia, *Final Report of the Commonwealth Task Force on Occupational Superannuation* (1983) [1.10].

145 Commonwealth Taskforce, Commonwealth Government of Australia, *Final Report of the Commonwealth Task Force on Occupational Superannuation* (1983) [2.1]-[2.29].

146 Treasury of Australia, 'Towards higher retirement incomes for Australians: a history of

movement and industrial relations negotiations, as superannuation provided a way for members to obtain deferred wage increases without breaching the then centralised wage fixation system.[147] Union influence was particularly evident during negotiation of the 1983 Statement of Accord (Accord) between the Australian Labor Party (ALP) and the Australian Council of Trade Unions (ACTU).[148] It was agreed that social security policy should seek to redress anomalies in the availability of occupational superannuation benefits.[149] The Government then confirmed its support for widespread superannuation saving during its May 1983 Economic Statement and in particular the principles of occupational superannuation.[150]

Soon after this time the ACTU initiated *National Wage Case June 1986*[151] was brought before the Conciliation and Arbitration Commission (CAC). The ACTU sought a 4% increase in wages, salaries and allowances, with reserve for exemption of an employer where a 3% wage equivalent was paid on behalf of employees into a superannuation fund.[152] The claim was successful and withstood a subsequent challenge on constitutional grounds,[153] leaving unions free to secure superannuation award claims for their members. The outcome then influenced the negotiation of the 1986 Accord Mark II, under which the Government and unions agreed to an increase in employee compensation, comprising 3% employer superannuation, a 2% wage increase and cuts in taxation.

Further encouragement to participate in superannuation ensued from the introduction of the OSSA in 1987. The OSSA prescribed the standards for compliance by superannuation funds to be eligible to receive a concessional taxation treatment. The Insurance and Superannuation Commission (ISC) took oversight of the compliance with these operating standards and other relevant conditions.[154] The FCT determined eligibility for a concessional taxation treatment by reference to the annual return, trustee's certificate and auditor's certificate to be submitted

the Australian retirement income system since Federation' (Economic Round up Centenary Edition, 2001) 74.

147 Treasury of Australia, 'Towards higher retirement incomes for Australians: a history of the Australian retirement income System since Federation' (Economic Round-up Centenary Edition, 2001) 77.

148 Pursuant to the terms of the Accord it was agreed that wage increases would be restricted to movements in the CPI.

149 Australian Labor Party and Australian Council of Trade Unions, *Statement of Accord by the Australian Labor Party and the Australian Council of Trade Unions Regarding Economic Policy* (1983) 1-37, 24.

150 Paul Keating, Treasurer, 'Economy' (Ministerial Statement, 19 May 1983).

151 (1986) 14 IRJ 187.

152 *National Wage Case* (1986) 14 IRJ 187, 202 (CAC).

153 *Re Manufacturing Grocers' Employees Federation of Australia; Ex parte Australian Chamber of Manufacturers ("Superannuation case")* (1986) 160 CLR 341. The challenge was made on the basis that superannuation was not an industrial matter within s 51 (xxxv) of the Constitution, which limits the Commonwealth's jurisdiction to conciliation and arbitration matters.

154 The ISC was established by the *Insurance and Superannuation Commissioner Act 1987* (Cth).

to the FCT by each superannuation fund after the end of the income year.[155] The further requirement for each superannuation fund to pay an annual fee meant that no net cost from administering these arrangements was anticipated.[156] These measures expressed the Government's now clear policy interest in regulating superannuation, protecting member interests and ensuring its proper use for retirement income purposes. By 1988 superannuation coverage had grown to include 62% of all employees.[157]

Despite these gains, the Government remained committed to further expand superannuation coverage. The objective was assisted in 1992, when award superannuation was replaced with compulsory SG requiring contributions made by employers on behalf of their employees. For this purpose the meaning of the word "employee" included but also extended beyond its common law meaning, giving the regime a broad application.[158] Compulsion to participate was enforced through a Superannuation Guarantee Charge (SGC) and would ultimately increase the level of employer funded superannuation contributions from the existing 3% award superannuation to the current 9.5% of an employee's earnings base. The effectiveness of the SG regime was reflected by the fact that by 1993 superannuation coverage extended to 80% of all employees.[159]

Further improvements to the regulatory arrangements for superannuation were achieved in 1993 with the introduction of the SISA regime. The new prudential arrangements were intended to establish a more comprehensive and effective prudential framework to give increased protection of superannuation savings, while avoiding unreasonable supervisory and compliance costs.[160] The role of trustees was enhanced through clearly defining their basic duties and responsibilities, and by ensuring that trustee powers were adequate to carry out their responsibilities. Members' interests were better protected though improvements to disclosure rules and an increased role for auditors and actuaries. The powers of the ISC were strengthened and the constitutional basis upon which regulatory arrangements relied was

[155] Explanatory Memorandum, Occupational Superannuation Standards Bill 1987 (Cth) 2.
[156] Explanatory Memorandum, Occupational Superannuation Standards Bill 1987 (Cth) 2.
[157] Australian Bureau of Statistics, 'Trends in superannuation coverage' (2009) 4102.0 *Australian Social Trends* 41. The coverage percentage was inclusive of owner managers of an incorporated enterprise as their main job and includes people with a superannuation account that may not attract contributions as having superannuation coverage.
[158] *Superannuation Guarantee (Administration) Act 1992* (Cth) s 12 (definition of "employee"). Refer Australian Taxation Office, 'Superannuation Guarantee Ruling SGR 2005/1 Superannuation Guarantee: who is an employee?' (2005).
[159] Australian Bureau of Statistics, 'Trends in superannuation coverage' (2009) 4102.0 *Australian Social Trends* 41. The coverage percentage is inclusive of owner managers of an incorporated enterprise as their main job and includes only those people with a superannuation account attracting contribution as having superannuation coverage.
[160] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 3.

changed to enable a broader range of sanctions, beyond the draconian removal of a superannuation fund's tax complying status.[161]

In 1997 the Financial System Inquiry Final Report[162] (Wallis Report) made recommendations on the efficiency, responsiveness, competitiveness and flexibility of the Australian financial system's regulatory arrangements.[163] In doing so, it took into account retirement incomes policy and recommended the establishment of a single agency to regulate corporations, financial market integrity and consumer protection.[164] It was considered efficient to link prudential regulation of superannuation, where required, with regulation to ensure compliance with retirement income policies, to ensure that superannuation providers were supervised by a single regulator.[165] As part of its response, the Government subsequently established the APRA[166] in 1998 to supervise banks, insurance and superannuation, other than small excluded superannuation funds (ESF) whose supervision was transferred to the ATO.

Fourth phase: 2000 to the present

The final phase for superannuation addresses the 2000s through to the present time. Consistent with trends towards earlier retirement and changing attitudes surrounding what level of retirement income is adequate, support for superannuation continues to be strong. The Government's commitment to the objectives of superannuation was particularly evident by the 2007 Simplified Superannuation[167] (Simpler Super) reforms. The objective of these legislative changes was to reduce the complexity of the tax and regulatory arrangements that apply to superannuation, improving retirement incomes and increasing incentives to work and save.[168] By 2007 superannuation coverage was established at 91% of all employees and has not materially changed since that time.[169]

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161 Refer SISA s19(3)(a), (b) (definition of "regulated superannuation fund") which required that the trustee of such a fund be a corporation within the meaning in s 51(xx) of the Constitution or that the scheme had the sole or primary purpose of providing old age pensions within the meaning in s 51(xxiii) of the Constitution. In contrast, the OSSA regime was relied for its efficacy on the taxation power in s 51(ii) of the Constitution.

162 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997).

163 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 31-73.

164 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 31.

165 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) [8.4.1].

166 *Australian Prudential Regulatory Authority Act 1998* (Cth).

167 Australian Government Treasury, *Simpler Super* (2006) < http://simplersuper.treasury.gov.au/>.

168 Explanatory Memorandum, Tax Laws Amendment (Simplified Superannuation) Bill 2006 (Cth); Superannuation (Excess Concessional Contributions Tax) Bill 2006 (Cth); Superannuation (Excess Non-Concessional Contributions Tax) Bill 2006 (Cth); Superannuation (Excess Untaxed Roll-Over

Further reviews produced the 2009 Australia's Future Tax System Report to the Treasurer[170] (Henry Report) and 2010 Super System Review Final Report[171] (Cooper Report), which contained a broad range of recommendations to improve the taxation and regulatory arrangements for superannuation. In response, Government initiatives were implemented as part of the Stronger, Fairer, Simpler: A tax plan for our future[172] reforms, such as increasing the rate of SG from 9% to 12% by July 2018[173] and a low income superannuation contribution to help increase member superannuation account balances.[174] Improvements to the function and efficiency of the superannuation system were also made as part of the Government's Stronger Super[175] (Stronger Super) program, including the introduction of MySuper[176] and Super Stream[177] products and enhanced trustee governance measures.[178] A self-assessment of these and related accomplishments claimed that they would boost the national superannuation savings pool by more than $500 billion by 2037 and produce an additional $127,000 in retirement for a thirty year old on average wages.[179] It is estimated that the total pool of superannuation saving is projected to exceed $9 trillion by 2040.[180]

However, the continued growth in superannuation savings has more recently led to the criticism of superannuation being too successful with some individuals accumulating

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Amounts Tax) Bill 2006 (Cth); Superannuation (Departing Australia Superannuation Payments Tax) Bill 2006 (Cth); Superannuation (Self Managed Superannuation Funds) Supervisory Levy Amendment Bill 2006 (Cth) 3.

169 Australian Bureau of Statistics, 'Trends in superannuation coverage' (2009) 4102.0 *Australian Social Trends* 41. The coverage percentage is inclusive of owner managers of an incorporated enterprise as their main job and includes only those people with a superannuation account attracting contribution as having superannuation coverage.

170 Taxation Review Panel, *Australia's Future Tax System Report to the Treasurer* (2009).

171 Superannuation Review Panel, *Super System Review Final Report* (2010).

172 Commonwealth of Australia, 'Tax Policy Statement, Stronger, Simpler, Fairer: A tax plan for our future' (2010).

173 *Superannuation Guarantee (Administration) Amendment Act 2012* (Cth).

174 *Tax Laws Amendment (Stronger, Fairer, Simpler and Other Measures) Act 2012* (Cth).

175 Australian Government Treasury, *Stronger Super* (2013) <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>.

176 *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012* (Cth); *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (Cth).

177 *Superannuation Legislation Amendment (Stronger Super) Act 2012* (Cth); *Superannuation Supervisory Levy Imposition Amendment Act 2012* (Cth).

178 *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth); *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* (Cth).

179 Bill Shorten, Minister for Financial Services and Superannuation, 'Super Bills Pass Parliament and Mark Completion of Reform Agenda' (Media Release, No 53, 25 June 2013).

180 Commonwealth of Australia, *Financial System Inquiry Interim Report* (2014) 2-84. The precise rate of future growth in superannuation is difficult to estimate. Some estimates have factored in higher rates of growth that suggest superannuation fund assets would exceed $12 trillion by the late 2030s.

excessive savings.[181] Detractors have queried the growing size of its taxation expenditures, raised equity concerns surrounding who benefits most from those expenditures and revisited the extent that superannuation is effective in decreasing reliance on the old age pension.[182] Whether responding to these matters or the reality of increased budgetary pressures, the scheduled increases in the rate of SG have now been deferred.[183] Further reforms announced in the Governments 2016-17 Budget[184] have also now been enacted with the aim of making more superannuation fiscally sustainable, such as limiting superannuation contributions and amounts transferable to retirement phase accounts.[185] It would appear that superannuation has reached an important juncture, where Government and ALP[186] policy suggest that superannuation saving should be successful, though perhaps not too successful.

Conclusion – superannuation evolves

The development of superannuation in Australia has progressed slowly, from humble beginnings to achieve broad coverage and an important source of retirement income for many Australians. Yet superannuation has never provided the only source of retirement income, with the old age pension and voluntary private saving playing important roles. It has also enjoyed different levels of government support over time. The significance of superannuation became clearer after the after the National Wage Case, which prompted the Government to formalise its retirement incomes policy.[187]

Retirement incomes policy was initially based on the twin pillars of the old age pension system and private savings.[188] Although superannuation contributed to the second pillar, it was not deserving of separate recognition given that even the 3% award contribution established under the Accord Mark II would provide only a modest supplement to the old age

[181] Bruce McDougall and Jessica Marszalek, ‘PM tells a rich 4pc of Aussies to get real on super plan’, *Daily Telegraph*, 3 June 2016, 10.
[182] Adam Creighton, ‘Australia’s $2 trillion super pile a costly exercise in pyramid building’, *The Australian*, 19 February 2016, 32; Joanna Mather and Sally Rose, ‘Mandatory super comes under fire’, *Australian Financial Review*, 22 February 2016, 1; Jennifer Hewett, ‘Super ‘gift’ too tempting for Turnbull’, *Australian Financial Review*, 11 March 2016, 2; Joanna Mather and Sally Rose, ‘Low tax sought for $2.5m super’, *Australian Financial Review*, 11 March 2016, 6.
[183] Joe Hockey, Treasurer, ‘Rephasing superannuation guarantee’ (Media Release, 13 May 2014).
[184] Commonwealth of Australia, *Budget 2016-17, Budget Measures, Budget Paper No.2* (2016) 24-30.
[185] *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).
[186] Australian Labor Party, *Labor’s Fairer Super Plan* <http://www.alp.org.au/fairer_super_plan>.
[187] Commonwealth of Australia, Department of Social Security, ‘Towards a National Retirement Incomes Policy’ (Social Security Review, Issues Paper No. 6, 1988).
[188] Brian Howe, Minister for Social Security, ‘Better Incomes: Retirement Income Policy into the Next Century’ (1989) iv.

pension.[189] However, the introduction of the SG increased the contribution made by superannuation and subsequently a three pillar retirement incomes policy was adopted: the age pension and associated social security arrangements; compulsory superannuation through the SGC; and voluntary superannuation encouraged by taxation concessions up to a reasonable benefit limit (RBL).[190] The third pillar was subsequently clarified to be voluntary private savings, including through superannuation.[191]

Government support for superannuation enabled it to achieve broad coverage, ultimately exceeding 90% of employed persons and providing an important source of retirement income. Yet in view of the extent of associated taxation expenditures and particular equity concerns surrounding the distribution of those benefits, superannuation unsurprisingly receives particular scrutiny. The need to clarify the role of superannuation was identified in the 2014 Financial System Inquiry Final Report (FSI Report), recommending that the objectives of superannuation be enshrined in legislation so as to ensure policy proposals are consistent with achieving those objectives in the long term.[192] That matter is now under consideration by Government,[193] focussed by continued budgetary pressures, evolving applications of superannuation linked to family wealth accumulation and possible risks for the economy from investment choices. These concerns and its turbulent history suggest that the role of superannuation will continue to evolve, and importantly for this thesis remain receptive to suggestions for legislative reform. In order to withstand scrutiny, proposals should be based on a clear understanding of the taxation and regulatory regimes within which superannuation funds exist.

2.4.2 Superannuation and taxation

Background

Beyond revenue collection, a basic role of income taxation is to encourage individuals to participate in superannuation so as to provide their own source of retirement income. Consistent with the gradual historical development of superannuation in Australia,[194] the

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189 Brian Howe, Minister for Social Security, 'Better Incomes: Retirement Income Policy into the Next Century' (1989) 23.
190 John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992) 5.
191 Treasury of Australia, 'Submission to Senate Select Committee on Superannuation Inquiry into Superannuation and Standards of Living in Retirement' (2002) 7.
192 Commonwealth of Australia, *Financial System Inquiry Final Report* (2014) 97-98.
193 Superannuation (Objective) Bill 2016 (Cth).
194 Refer section 2.4.1 of this thesis.

extent of encouragement provided by taxation has varied over time.[195] Early taxation law was also tasked with a regulatory role for superannuation, constraining the activities that a superannuation fund could undertake whilst still remaining eligible for a concessional taxation treatment. The eventual introduction of award superannuation and later the SG pushed the imperative for a separate prudential approach and the regulatory role of taxation law abated.

Given its importance to the success of superannuation, it appropriate to provide a historical account of how superannuation-related taxation law has evolved. Taxation measures are particularly important for this thesis, being a key co-dependency in the conceptualisation of the SMSF substance and its ultimate recommendation for reform in Chapter 6.[196] However, this task presents some difficulty given that taxation law has offered an irresistible temptation for Government tinkering, leaving a voluminous and often messy trail of amendments. For that reason, it is not intended to cover all taxation developments. To provide a sense of structure the various changes have been considered under the time periods corresponding to the four identified phases of occupational superannuation.[197]

First phase – superannuation-related taxation law: 1915 to the 1940s

The discussion of early superannuation developments identified the role of taxation incentives to encourage member participation. This occurred through relief from income taxation, which in itself has existed in Australia from 1884 with the Colony of South Australia, and subsequently extending to all other Australian Governments,[198] the last of which was the Commonwealth in 1915.[199] Although taxation arrangements of individual colonies may have addressed superannuation, this thesis is concerned with measures introduced by the Commonwealth Government. This is an efficient approach, given that Commonwealth eventually took exclusive control over income taxation matters.

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[195] The more significant taxation influences that have changed over time include: the marginal rates of individual personal taxation (creating tax arbitrage opportunities), the taxation rates on superannuation fund income and capital gains, the taxation of contributions and benefit payments.

[196] Refer section 6.2.2 of this thesis.

[197] Refer section 2.4.1 of this thesis.

[198] Income tax was progressively adopted by Australian Governments by the following enactments: *Taxation Act 1884* (SA), *The Income Tax Act 1894* (Tas), *Land and Income Tax Assessment Act 1895* (NSW), *Income Tax Act 1895* (Vic), *Income Tax Act 1902* (Qld), *Land and Income Tax Assessment Act 1907* (WA) and *Income Tax Assessment Act 1915* (Cth).

[199] The Commonwealth had authority to impose income tax through the Constitution. After the enactment of the ITAA1915 the Commonwealth and the States both imposed income taxation, until the Commonwealth assumed exclusive control in 1942. The resulting vertical fiscal imbalance prompted the States to make two unsuccessful High Court challenges. Refer *South Australia v Commonwealth ("First Uniform Tax case")* (1942) 65 CLR 373; *Victoria v Commonwealth ("Second Uniform Tax case")* (1957) 99 CLR 575.

The ITAA1915 marked a historical starting point when examining the role of taxation and arrives during the first phase of occupational superannuation.[200] The initial position was extremely generous by modern standards: that the income of a provident, benefit, or superannuation fund established for the benefit of employees in any business was exempt from income taxation.[201] A deduction was available for sums set aside or paid by an employer of labour as or to a fund to provide individual personal benefits, pensions, or retiring allowances to employees, provided that the FCT was satisfied that the rights of the employees to those amounts were fully secured.[202] A deduction was also allowed for contributions not exceeding 50 pounds in aggregate by a taxpayer in receipt of salary or wages (and the like) for payments made to a superannuation fund.[203] The assessable income of a person included 5% of the capital value of a retiring allowance or gratuity paid in a lump sum, or, the whole of such amount where paid as an income stream.[204]

The *Income Tax Assessment Act 1922* (Cth) (ITAA1922) effected the first consolidation of the law governing the income tax assessment then contained in the *Income Tax Assessment Act 1915-1921* (Cth) (ITAA1915-1921). Despite some re-ordering of provisions, the substantive requirements surrounding superannuation fund income tax exemption, deductibility of contributions and assessability of benefit payments broadly remained.[205] One minor change from the ITAA1915 concerned the deduction for personal contributions made by a taxpayer to a superannuation fund. Specifically, the contribution cap had increased from £50 to £100, the scope of application broadened beyond employee taxpayers and the meaning of personal benefit expanded to include the taxpayer's wife and children.[206]

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[200] Refer section 2.4.1 of this thesis.
[201] ITAA1915 s 11(f).
[202] ITAA1915 s 18(j).
[203] ITAA1915 s 18(g).
[204] ITAA1915 s 14(f), 14(g).
[205] ITAA1922 s 14(f) provided an income tax exemption for superannuation funds established for the benefit of employees, though also included certain funds established for charitable purposes. Beyond a broader scope, the subsection was consistent with the earlier ITAA1915 s 11(f). ITAA1922 s 23(1)(j) provided a tax deduction for sums set aside or paid by an employer to provide individual personal benefits, pensions, or retiring allowances to employees, provided that the Commissioner was satisfied that the rights of the employees to those amounts had been fully secured. The paragraph was consistent with the earlier ITAA1915 s 18(j). ITAA1922 s 16(f) included in assessable income of any person 5% of the capital value of a retiring allowance or gratuity paid in a lump sum. The subsection was consistent with the earlier ITAA1915 s 14(f). ITAA1922 s 16(g) included in assessable income of any person all allowances or gratuities (other than lump sums), bonuses and premiums given or granted to a person in respect of or for or in relation, directly or indirectly, to any employment or service of such taxpayer to the amount of the value of such allowance, gratuity, bonus and premium. The subsection was consistent with the earlier ITAA1915 s 14(g).
[206] ITAA1922 s 23(1)(g) provided a deduction for payments not exceeding one hundred pounds in aggregate made for the personal benefit of the taxpayer or his wife or children during the year in

Next, the *Income Tax Assessment Act 1936* (Cth) (ITAA1936) consolidated the provisions of the *Income Tax Assessment Act 1922-1934* (Cth) (ITAA1922-1934). Beyond another re-ordering of provisions, the requirements for superannuation fund income tax exemption, deductibility of contributions and assessability of benefit payments were redrafted, though did not introduce significant in-principle change. The condition for superannuation fund income tax exemption was simplified, but the requirement that the fund be applied for the purposes for which it was established remained.[207] The tax concessional approach to lump sum benefits continued, subject to the payment occurring on retirement or termination from an office or employment and excluded private company deemed dividends dealt with elsewhere in the Act.[208] Other benefits remained fully assessable, though calculated at their value to the taxpayer and similarly excluded any private company deemed dividends.[209] Amounts set apart or paid by a taxpayer to fund benefits, pensions or retirement allowances of their employees remained deductible, subject to there being a legal obligation to set aside or pay such amounts. [210] The contribution cap for personal deductible contributions also remained, but the distinction between employees and other taxpayers for that purpose was removed.[211]

With further minor changes, these arrangements broadly remained in place through to the early 1940s. The lack of legislative reform during this period afforded superannuation funds

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which the income was derived by a taxpayer who is in receipt of salary, wages, allowances, stipends or annuity, or whose taxable income does not exceed eight hundred pounds, to superannuation. The scope of the subsection was broader than the earlier ITAA1915 s 18(g).

207 ITAA1936 s 23(j)(i) omitted the explicit requirement that the Commissioner be satisfied that the fund had been applied to its purposes. Apart from this change the paragraph was consistent with the earlier ITAA1922 s 14(1)(f).

208 ITAA1936 s 26(d) included in assessable income of any person 5% of the capital value of any allowance, gratuity or compensation paid in a lump sum in consequence of retirement or termination of employment, provided the payment was not a deemed private company dividend addressed elsewhere in the Act. Beyond the broader scope and exception for private company dividends, the subsection was consistent with the earlier ITAA1922 s 16(f).

209 ITAA1936 s 26(e) included in assessable income the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums given or granted to a person in respect of or for or in relation, directly or indirectly, to any employment of or service rendered, other than lump sums or deemed private company dividend addressed elsewhere in the Act. Beyond clarifying that the amount of assessable income was the value to the taxpayer and exception for private company dividends, the subsection was consistent with the earlier ITAA1922 s 16(g).

210 ITAA1936 s 66 provided a deduction for sums set apart or paid by the taxpayer in the year of income as or to a fund to provide individual personal benefits, pensions or retiring allowances for his employees as is proportionate to the extent that those employees are engaged in producing assessable income of the taxpayer, provided: (a) the taxpayer is under a legal obligation to set apart or pay that sum; and (b) the rights of the employees to receive the benefits, pensions or retiring allowances are fully secured. Beyond the requirement for the taxpayer to be under a legal obligation to set apart or pay the amounts, the section was consistent with the earlier ITAA1922 s 23(1)(j).

211 ITAA1936 s 79(e) provided a deduction for payments made by a taxpayer in a year of income not exceeding one hundred pounds in aggregate to superannuation made for the personal benefit of the taxpayer or of his spouse or children. The subsection removed the distinction between employed taxpayers and other taxpayers contained in the earlier ITAA1922 s 23(1)(g).

and members certainty and the opportunity to take advantage of superannuation taxation concessions with relatively limited restriction.[212] Despite this encouragement, there is reason to suspect that involvement in superannuation during this period was more influenced by difficult economic and war time conditions.[213] Limited participation would also have yielded lower levels of taxation expenditure on superannuation, which in turn may have reduced the need for legislative scrutiny. The passage of time makes it is difficult to locate empirical data to substantiate these contentions.

The end of World War II and improved economic conditions occurred late in the first phase of superannuation, bringing grounds to suggest its growing importance and popularity.[214] While in their infancy, reform to superannuation-related taxation laws was needed to respond to these changing circumstances. A particular focus was the deductibility of amounts paid or set apart to fund benefits or pensions for employees, responding to a tendency for companies to establish superannuation funds conferring a limited number of senior executives with inordinately large benefits to the exclusion of the general body of employees.[215] Amendments to the *Income Tax Assessment Act 1936-1943* (Cth) (ITAA1936-1943) were made to limit a taxpayer's deductions to £100 in respect of each employee or 5% of the employee's annual remuneration, whichever was the greater.[216]

Second phase – superannuation-related taxation law: 1950 to the 1970s

Consistent with growing levels of participation in the 1950s, the taxation constraints on superannuation fund activity typically increased during its second phase. However, early reforms in 1950 and 1952 also encouraged further saving through superannuation by increasing the deduction caps for payments to a superannuation fund for the personal

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212 Some change did occur during this period, for example the *Income Tax Assessment Act 1942* (Cth) repealed s 79 of the *Income Tax Assessment Act 1936-1941* (Cth) which had allowed a deduction for personal contributions for payments to superannuation (capped to one hundred pounds). It was replaced with a concessional rebate contained in s 160 *Income Tax Assessment Act 1936-1942* (Cth).

213 Refer section 2.4.1 of this thesis.

214 Senate Standing Committee on Community Affairs, Parliament of the Commonwealth of Australia, *Income Support for the Retired and the Aged: An Agenda for Reform* (1988) 162.

215 Explanatory Memorandum, Income Tax Assessment Bill 1944 (Cth) 13.

216 *Income Tax Assessment Act 1936-44* (Cth) ss 66(1)-(10). The Commissioner of Taxation retained discretion to allow a higher deduction in appropriate circumstances. Other than the introduction of monetary caps to limit deductions, provision for the Commissioner to exercise discretion for those caps to be exceeded and increased legislative prescription the subsections are consistent with the earlier s 66 of the ITAA1936. Where the taxpayer was not under a legal obligation to make such provision for their employees, then the *Income Tax Assessment Act 1936-1944* (Cth) s 79 provided a deduction for amounts voluntary paid or set aside by a taxpayer to fund personal benefits, pensions or retiring allowances for employees and adopted similar principles.

benefit of taxpayers, their spouse or child[217] and for amounts paid or set apart by taxpayers to provide individual personal benefit, pensions or retiring allowances for their employees.[218] Importantly for the self-employed population, changes in 1952 extended the income tax exemption to provident, benefit, superannuation or retirement funds that were not established for the benefit of employees.[219] The exemption conditions contained in s 23(ja) of the *Income Tax and Social Services Contribution Assessment Act 1936-1952* (Cth) (ITSSCA1936-1952) required that the number of persons entitled to benefit from the fund was not less than twenty persons and the terms and conditions of the fund had been approved by the FCT.

A significant change occurred in 1961 to make the income tax exemption of superannuation funds established for the benefit of employees or approved funds for non-employees conditional on satisfying conditions in a new Division 9B of Part III of the ITSSCA1936-1961. Its main upshot was that the income tax exemption available to s 23(j) funds and s 23(ja) funds became subject to a 30-20% ratio of public securities.[220] This required a superannuation fund to hold public securities amounting to not less than 30% of its total assets, including Commonwealth securities amounting to not less than 20% of that holding. The constraint responded to the practical difficulties faced by Commonwealth and State Governments in financing their public works expenditures.[221] However, from a superannuation fund perspective, the change highlights the co-dependency theme, accepting legislative restrictions in return for continued access to a concessional taxation treatment.[222]

For many superannuation funds this intrusion was unwelcome. It was soon challenged on constitutional grounds in *Fairfax v FCT*[223] (*Fairfax case*). The argument was raised that s 11 of the *Income Tax and Social Services Contribution Assessment Act 1961* (Cth), which inserted Division 9B into the *Income Tax and Social Services Contribution Assessment Act*

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217 *Income Tax and Social Services Contribution Assessment Act 1936-1950* (Cth) s 82H. The deduction of up to £200 replaced a rebate (that was introduced to replace a deduction) for personal superannuation contributions. The rebate was abandon due to its complexity for taxpayers and the administration.

218 *Income Tax and Social Services Contribution Assessment Act 1936-1951* (Cth) s 66 provided a deduction of up to £200 where the taxpayer was under a legal obligation to set apart or pay that sum. *Income Tax and Social Services Contribution Assessment Act 1936-1951* (Cth) s 79 provided a deduction of up to £200 where the amounts were voluntarily set apart or paid.

219 *Income Tax and Social Services Contribution Assessment 1936-1952* (Cth) s 23(ja) inserted by *Income Tax and Social Services Contribution Assessment (No.3) 1952* (Cth).

220 ITSSCA1936-1961 Division 9D. Refer section 2.3 of this thesis identifying this peculiar feature for the existence of a superannuation fund.

221 Harold Holt, Treasurer, 'Income Tax and Social Services Contribution Assessment Bill 1961' (Second Reading Speech delivered at the House of Representatives, Canberra, 26 April 1961) 1151.

222 The requirement was eventually by *Taxation Laws Amendment Act 1985* (Cth).

223 (1965) 114 CLR 1.

1936-1960 (Cth), was not a valid use of the Commonwealth's taxation power under the Constitution.[224] However, the High Court rejected that contention, confirming the use of the taxation power over superannuation fund investment, an area over which the Commonwealth lacked direct constitutional power to regulate. Menzies J, with whom Barwick CJ agreed observed:[225]

> ...by affording a conditional taxation exemption, obviously provides a financial inducement to the trustees of superannuation funds affected to invest in public securities and in Commonwealth securities. Full recognition of this does not mean, however, that s. 11 is not what it appears to be, viz. a law with respect to taxation.

Kitto J provided similar comment:[226]

> The legislative policy is obvious and may be freely acknowledged: it is to provide trustees of superannuation funds with strong inducement to invest sufficiently in Commonwealth and other public securities.

The *Fairfax case* endorsed the Government's control over superannuation funds through the use of its taxation power. At this point the co-dependency theme was solely a function of taxation law, offering a concessional tax treatment in return for adherence to taxation constraints on superannuation fund activity. The growing conflict between increased constraint and earlier flexibilities soon emerged through increased revenue litigation, addressing abuse of the superannuation tax concessions previously not seen prior to the mid-1960s.[227] The first cases to emerge typically involved an arrangement whereby a superannuation fund was established by deed for the benefit of employees of a private company, but in practice operated to reduce the taxable profits of that company to benefit its shareholders.[228]

Addressing concerns surrounding the integrity of taxation arrangements for superannuation, a wide ranging review of those rules produced the Ligertwood Report. The ensuing recommendations were broadly aimed at strengthening the co-dependency theme, suggesting that further restrictions on superannuation fund activity were necessary in return for their continued income tax exemption. The Ligertwood Report distinguished a s 23(j) fund, being a "provident, benefit or superannuation fund established for the benefit of employees" from a s

224 Constitution s 51(ii).
225 (1965) 114 CLR 1, 17.
226 (1965) 114 CLR 1, 13.
227 Note, 'Superannuation Funds – Section 23(j) – Private Company Dividends' (1966) 40 *Australian Law Journal* 62.
228 Refer *Mahoney v FCT* (1965) 39 ALJR 62; *Compton v FCT* (1966) 116 CLR 233.

23(ja) fund “not being a fund established for the benefit of employees” whose terms had been accepted by the FCT. Although there were no acknowledged abuses of s 23(ja) funds, presumably due to their more rigorous approval procedures, it was apparent from submissions that a number of s 23(j) funds were not bona fide established for the benefit of all participating employees.[229]

The Ligertwood Report identified complexity in the taxation law concerning the permitted level of contributions, allowing some members to access greater benefits than were intended to be possible. The primary concern related to contributions being made for relatives that were otherwise unconnected to the contributor, multiple contributions of the statutory maximum on behalf of one employee from associated companies, contributions in respect of shareholders and contributions for directors with only nominal duties.[230] It was recommended that these matters be addressed by repealing the existing tax deduction for contributions on behalf of employees of persons other than the contributing taxpayer, and strengthening the tax deduction requirements for contributions by an employer on behalf of employees with further integrity measures.[231]

When considering the deductibility of contributions, the Ligertwood Report observed an inequity of the self-employed who were unable to claim a tax deduction for their contributions to a s 23(ja) fund, other than a deduction available to all taxpayers, self-employed and employees, on the same basis.[232] In contrast, an employer was permitted to make a deductible contribution of up to £200 or 5% of an employee’s salary to a superannuation fund for the benefit of that employee.[233] To partially remove this inconsistency it was recommended that the self-employed be entitled to a deduction of up to £200 for additional personal contributions made during an income year. Reflecting the historical focus on superannuation funds established for the benefit of employees, there was little desire to treat the two types of superannuation fund equally. Equivalence in the tax deductibility of superannuation contributions was not recommended for “obvious reasons”

229 Ligertwood Report 154.
230 Ligertwood Report 153.
231 Ligertwood Report 153.
232 Refer ITSSCA1936-1964 s 82H. Section 82H was inserted by the *Income Tax and Social Services Contribution Assessment Act 1950* (Cth) and initially allowed a deduction for personal contributions of up to £200 pounds in respect of any one year of income. At the time of the Ligertwood Report the deduction limit had increased to £400.
233 Assuming that the maximum level of contribution was made during an income year, this situation would result in an employee receiving £600 in contributions to their member account whilst a self-employed person would receive £400.

and the undesirability of drawing too close an analogy between self-employed and employed persons.[234]

The *Income Tax and Social Services Contribution Assessment Act 1936-1963* (ITSSCA1936-1963) was amended to address many of these concerns. One change was to replace s 23(j) of the ITSSCA1936-1963 with s 23F of the ITSSCA1936-1964. Consequently, the income tax exemption for superannuation funds established and maintained solely for the benefit of employees was limited by excluding income from transactions entered into on a non-arm's length basis or, in the absence of the FCT discretion, dividends received from a private company.[235] The changes also introduced a tax deduction equal to 5% of the net assets of a superannuation fund for those that came within s 79 of the ITSSCA1936-1964.[236] This category of s 79 funds dealt with those that provided benefits for members upon retirement from "a business, trade, profession, vocation, calling or occupation" that failed to satisfy s 23F of the ITSSCA1936-1964 or the tests pertaining to s 23(ja) funds for the self-employed.[237]

The amendments also inserted Subdivision AA of Division III of the ITSSCA1936-1964 to replace the existing tax deductibility requirements for contributions on behalf of employees.[238] Contributions in respect of employees engaged in providing assessable income of their employer remained deductible, though the deductibility of contributions for the benefit of an employee with whom the contributor had no business relationship was restricted.[239] Deduction limits for an eligible employee continued to be the greater of £200 or 5% of their annual remuneration for that year, though ensured that the aggregate deductions available to different persons for contributions on behalf of the same individual were limited

234 Ligertwood Report 151.

235 Consistent with the previous law, the exemption under ITSSCA1936-1964 s 23F remained contingent upon the superannuation fund satisfying the 30%-20% ratio of public securities.

236 Somewhat confusingly, ITAA1936-1963 s 79 previously concerned the deductibility of voluntary contributions to a superannuation fund established for the benefit of employees.

237 ITSSCA1936-1964 s 79. The deduction was applied to fund earnings, other than earnings from private company dividends (absent Commissioner discretion) or income from non-arm's length dealing that was higher than would be expected had the parties been dealing at arm's length and was not contingent on holding a 30%-20% ratio of public securities.

238 ITSSCA1936-1964 Subdivision AA of Division III inserted by *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964* (Cth). The former deduction provisions contained in ITSSCA1936-1963 ss 66 and 79 were repealed.

239 Refer ITSSCA1936-1964 s 82AAA(1)(a) (definition of "eligible employee") and ITSSCA1936-1964 s 82AAC addressing deductibility of contributions. Under the new ITSSCA1936-1964 s 82AAA contributions for the benefit of employees or his dependents were deductible where made by: an employer of the employee, a contributor having a controlling interest in the employer, a company in which a controlling interest is owned by the employer or person who owns a controlling interest in the employer, a partner in a partnership which is the employer or a non-associated contributor who owns shares in a company employing the employee.

to the statutory maximum.[240] Further integrity measures prevented the deduction limits being circumvented through the transfer to one employee of benefits lost or forfeited on the resignation or dismissal of other employees.[241]

In 1973 the deductibility of personal contributions to a superannuation fund received further scrutiny. The *Income Tax Assessment Act 1936-1972* (Cth) was amended to ensure that a deduction for these types of contribution was conditional upon the recipient superannuation fund being an income tax exempt s 23F or s 23(ja) fund or a concessional s 79 fund.[242] These restrictions ensured that the deduction for superannuation contributions were appropriately targeted, but were relatively short-lived being replaced in 1975 with a rebate rather than a deduction.[243] Essentially, this adopted an earlier rebate approach for personal superannuation contributions that was previously abandoned due to its complexity for the tax administration and practitioners.

The taxation reforms introduced during the second phase of occupational superannuation were particularly necessary in light of the high marginal rates of personal income taxation in comparison to the taxation exemption enjoyed by superannuation funds.[244] This arbitrage provided an incentive to maximise contributions that would otherwise be taxable to the individual and attracted avoidance type activity demanding an integrity response. In some cases, taxation reforms begin to exhibit protective characteristics, limiting superannuation fund activities that benefited employers or senior management to the detriment of the general body of members. In other instances, taxation restrictions were simply a trade-off for continued access to an income tax exemption, enabling the Government to fund its unrelated financial commitments.

Third phase – superannuation-related taxation law: 1980 to the 1990s

During the early 1980s the taxation reforms again focussed on removing some of the disparities between the different types of superannuation fund. In 1980 a new Subdivision AB of Pt III of the ITAA1936 addressed differences in the ability to make tax deductible

[240] ITSSCA1936-1964 ss 82AAE-82AAF.
[241] ITSSCA1936-1964 s 82AAG.
[242] *Income Tax Assessment Act 1936-1973* (Cth) s 82H(1G).
[243] *Income Tax Assessment Act 1936-1975* (Cth) s 159R, inserted by *Income Tax Assessment Act (No.2) 1975* (Cth).
[244] The highest marginal rate reached 75% in the 1950s. Refer Australian Government Treasury, Economic Roundup Winter 2006, A *brief history of Australia's tax system* (2006) <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

contributions to s 23F funds, s 23(ja) funds and s 79 funds.[245] Accordingly, contributions by an eligible person (not in receipt of employer superannuation support) to the latter categories of fund were made deductible subject to a cap of $1,200 per income year.[246] Similarly, the taxation of lump sum retirement benefits from s 23(ja) and s 79 funds became taxable on an equivalent basis to s 23F funds, with 5% of the payment being included in the recipients assessable income.[247] These changes were accompanied with integrity measures to safeguard against abuse of the available deductions by contributors and provide sanctions for benefits extracted otherwise than in accordance with the terms and conditions applicable to the fund.[248] Particular concerns were unauthorised payments in the guise of loans to members and the assignment of the rights to receive benefits.[249]

Further concern for superannuation integrity is evident from the insertion of a further Division 9C of Part III of the ITAA1936 in 1981.[250] The purpose of the Division was to assess taxable income diverted under tax avoidance arrangements from individuals and companies to tax exempt entities, including superannuation funds.[251] The general theme of the targeted schemes was that a tax-exempt body acquired property from which income would arise and but for its general taxation exemption be included in assessable income.[252] The exempt body derived little benefit as it was then required to reimburse the person from whom the income was diverted, providing consideration in a tax-free form.[253] The amount of the consideration paid would typically equal most of the diverted income and exceed what would be expected to be paid were the entity not tax exempt. Where the arrangement was caught, the exempt body would be taxed at the rate applicable to a trustee of a trust under s 99A of the ITAA1936.[254]

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245 ITAA1936 Subdivision AB of Pt III inserted by the *Income Tax Assessment Amendment Act (No.4) 1980* (Cth).

246 ITAA1936 ss 82AAS, 82AAT. Previously these contributions were merely entitled to a rebate under ITAA1936 s159F on the same basis as personal contributions to superannuation by employees.

247 ITAA1936 s 26AE. This affected payments not in the form of income (such as pensions that were fully taxable) and only to the extent that the payment was attributable to contributions deducted under ITAA1936 s 82AAT and earnings on those amounts. Previously the non-deductibility of contributions to these types of superannuation fund meant that lump retirement benefits were tax free.

248 ITAA1936 ss 26AF(1), (2).

249 Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 4) 1980 (Cth) 9.

250 ITAA1936 Division 9C of Part III, inserted by *Income Tax Laws Amendment Act 1981* (Cth).

251 Explanatory Memorandum, Income Tax Laws Amendment Bill 1981 (Cth) 7.

252 Explanatory Memorandum, Income Tax Laws Amendment Bill 1981 (Cth) 60.

253 Explanatory Memorandum, Income Tax Laws Amendment Bill 1981 (Cth) 60.

254 ITAA1936 s 121H, inserted by *Income Tax (Diverted Income) Act 1981* (Cth). The rate payable by a trustee of a trust under ITAA1936 s 99A was 60% for the 1980-1981 income year, being the maximum rate of personal income taxation.

While the top marginal rate of individual income taxation had declined from its historical peak, it continued to remain well above 50% during the 1980s.[255] Despite continued efforts to ensure taxation concessions were not misused, the incentives for participants to maximise their benefits continued. For those individuals close to retirement there was a particular incentive to direct salary income into superannuation, to be withdrawn later as a lump sum retirement benefit and assessed on only 5% of such amount. In 1983 the taxation treatment of lump sum superannuation benefits came under scrutiny, with a new Subdivision AA in Division 2 of Part III the ITAA1936 to deal with superannuation, termination of employment and kindred payments.[256] The subdivision created four categories of payment, each of which attracted different rates of taxation.[257]

Further efforts were also made to reduce the taxation disparities between the different types of superannuation fund, focusing on s 79 funds. While s 23F and s 23(ja) funds were exempt from income taxation, s 79 funds were less concessional and only entitled to a tax deduction equal to 5% of their net assets. The inequity was removed in 1984 by replacing s 79 of the ITAA1936 with s 23FB of the ITAA1936.[258] The new s 23FB of the ITAA1936 provided an income tax exemption, continued the requirements of the earlier provision and consistently adopted limitations in relation to private company dividends and other non-arm's length income.[259] A further disparity was removed in 1985 upon the abolition of the 30/20% ratio of public securities requirement for s 23F and s 23(ja) funds.[260]

During 1985 statutory investment rules imposed further constraint on superannuation fund activities, addressing the safety of member superannuation savings by limiting their exposure to the ongoing profitability of an employer-sponsor.[261] Division 9B of the ITAA1936 was amended to introduce the concept of an "in-house asset", meaning an asset of a

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255 Australian Government Treasury, Economic Roundup Winter 2006, A *brief history of Australia's tax system* (2006) <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

256 ITAA1936 Subdivision AA Div 2 Part III inserted by *Income Tax Amendment Act (No.3) 1984*. In particular, refer ITAA1936 ss 27A-27H.

257 The first part of a payment was the before 1 July 1983 component, referable to service or superannuation fund membership up to 30 June 1983, with 5% of such payments included in assessable income. The second part comprised contributions made after 30 June 1983 that did not attract a tax deduction, which were tax free. The third part included eligible termination payments, reduced by amounts included in the second part, referable to service or membership after 30 June 1983. These payments were subject to a rebate to ensure that, depending on the amount and age of the recipient, the payment was taxed at a flat rate of 15% or 30%. The fourth part was the concessional component (bona fide redundancy, an approved early retirement scheme or invalidity payment) of an eligible termination payment, with 5% being included in assessable income.

258 ITAA s 23FB, inserted by the *Income Tax Assessment Amendment Act (No.3) 1984* (Cth).

259 Refer Explanatory Memorandum, Income Tax Assessment Amendment Act (No.3) 1984 (Cth) 23.

260 ITAA1936 s 121C, repealed by *Taxation Laws Amendment Act 1985* (Cth).

261 Explanatory Memorandum, Tax Law Amendment Bill (No.2) 1985 (Cth) Part A, 7.

superannuation fund that consisted of a loan to, or an investment in, an employer-sponsor of the fund or an associate of thereof.[262] Subject to transitional rules, the investment income of a s 23F fund or s 23FB fund was no longer exempt from income tax, unless at all times during the income year, the cost of the in-house assets of the superannuation fund did not exceed 10% of the cost of all the assets of the fund.[263]

From 1 July 1986 the in-house asset constraints in the ITAA1936 began a period of transition in which they were phased out and replaced with provisions in the OSSA regime.[264] Initially the accompanying OSSR standards deferred to the taxation law in-house asset constraints,[265] before later containing their own substantive requirements with effect from 1 July 1990.[266] Where a superannuation fund failed to obtain a notice of approval due to non-compliance with the OSSA in-house investment requirement, its ineligible income from such assets would be taxed at the highest marginal rate of income taxation.[267] Accompanying provisions similarly ensured that private company dividends and other excessive non-arm's length income were not concessionally taxed.[268] Section 23FC of the ITAA1936 was also inserted to replace and consolidate the previous s 23F and s 23FB categories of superannuation fund, essentially being a superannuation fund that had received notice of compliance with the OSSA.[269]

The generous income tax exemption available to superannuation funds was tempered from 1 July 1988, a decision that was likely influenced by growing coverage achieved by award superannuation and implications for the budget of growing tax expenditures.[270] Pt IX of the ITAA1936 was introduced with the effect that a complying superannuation funds became liable to income tax at 15% on the standard component and 49% on the special component of their taxable income,[271] though maintaining an exemption for income attributable to current

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262 ITAA1936 s 121C(1), inserted by *Taxation Laws Amendment Act (No.2) 1985* (Cth).
263 ITAA1936 s 121C(4), inserted by *Taxation Laws Amendment Act (No.2) 1985* (Cth). As an integrity measure under ITAA1936 s 121C(12), in-house assets included the amount of any indirect investment by the superannuation fund in the employer-sponsor or an associate of an employer-sponsor.
264 ITAA1936 s 121CC(1) was inserted to assess investment income derived by a superannuation fund that failed to meet the in-house asset investment requirements contained in the OSSA. Refer *Taxation Laws Amendment Act (No 4) 1987* (Cth).
265 OSSR reg 16.
266 OSSA reg 16A.
267 ITAA1936 s 121CC. The balance of the superannuation fund's income would be taxed at a lower rate of 24%.
268 ITAA1936 s 121D, inserted by *Taxation Laws Amendment Act (No 4) 1987* (Cth).
269 ITAA1936 23FC, inserted by *Taxation Laws Amendment Act (No 4) 1987* (Cth).
270 Explanatory Memorandum, Taxation Laws Amendment Bill (No.6) 1988 (Cth) 3.
271 ITAA1936 Pt IX, inserted by *Taxation Laws Amendment Act (No.2) 1989* (Cth). ITAA1936 Pt IX Division 3 provided a comprehensive code for the assessment of complying superannuation funds. In particular, refer ITAA1936 s 285 for standard component of a complying superannuation fund's

pension liabilities.[272] A complying superannuation fund was one that had received a notice of compliance with the OSSA operational standards,[273] in comparison to non-complying superannuation fund that had not been so notified and was taxed at the top marginal rate of taxation.[274]

To partially compensate the revenue effects of Pt IX of the ITAA1936, the taxation rates applicable to the taxed element of a lump sum superannuation benefit were reduced to nil up to a low rate threshold of $60,000 and 15% for amounts above this threshold.[275] Although the taxable component of an annuity continued to be assessed at the recipient individual's marginal rate, the amount due was reduced by the introduction of a 15% rebate.[276] The contribution cap for deductible contributions made by an employer was also removed,[277] while the cap for contributions to personal superannuation funds by self-employed persons was less generously increased from $1,500 to $3,000 for the 1989 and subsequent income years.[278] Further amendments were made to ensure that a superannuation fund that was taxable under Pt IX of the ITAA1936 was entitled to franking rebates in relation to their franked dividend income.[279]

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taxable income, ITAA1936 s 284 for the special component of a complying superannuation fund's taxable income, ITAA1936 s 283 for the exemption of a complying superannuation fund's income attributable to current pension liabilities. *Income Tax Rates Act 1986* (Cth) s 26(1)(a), (b) provided the tax rates of 15% and 49% for a complying superannuation fund.

272 ITAA1936 s 283 exempted income based on the proportion of a superannuation fund's income that its current pension liabilities bore to its total liabilities.

273 ITAA1936 s 267 (definition of "complying superannuation fund").

274 ITAA1936 s 267 (definition of "non-complying superannuation fund"). ITAA1936 Pt IX Div 4 provided a comprehensive code for the assessment of non-complying superannuation funds. *Income Tax Rates Act 1986* (Cth) s 26(2) provided the tax rate of 49% for a non-complying superannuation fund. On this basis, there was only one class of non-complying superannuation fund to be taxed at the top marginal rate of 49%. This replaced earlier arrangements whereby superannuation funds that failed the tests for income tax exemption were taxed on their income at different taxation rates depending on the reason for their failure. For example, a superannuation fund that failed the standards other than loan-back restrictions were taxed on their income at 40% (ITAA1936 s 121DAB), superannuation funds that failed the loan-back standard were taxed on their income at 24% (ITAA1936 s 121CC), superannuation funds that did not need the definition of a superannuation fund in the OSSA were taxed at 49% (ITAA1936 s 121DA).

275 ITAA1936 Subdivision AAA Div 17 Part III, inserted by *Taxation Laws Amendment (Superannuation) Act 1989* (Cth). The change was implemented over a transitional period with full effect from 1 July 1992.

276 ITAA1936 Subdivision AAB Div 17 Part III, inserted by *Taxation Laws Amendment (Superannuation) Act 1989* (Cth).

277 ITAA1936 s 82AAC, with effect from 1 July 1988. Further amendments to ITAA1936 ss 82AAC, 82AAR with effect from 30 November 1988 denied a deduction for amounts set apart but not actually paid. In addition, while the cap was removed a complying superannuation fund would still need to satisfy the ISC that it was providing benefits within prescribed reasonable benefit limits.

278 ITAA1936 s 82AAT(2).

279 ITAA1936 s 160AQU(b)(ii), omitted and substituted by *Taxation Laws Amendment Act (No.2) 1989* (Cth).

In 1992 significant taxation reform occurred through the introduction of the SG, supporting the Government's retirement income policy and ambitions to extend both coverage and the amount of retirement saving accumulated through occupational superannuation.[280] Compulsion to participate was reflected by the SGC, being a tax on employers that failed to provide the required minimum level of superannuation support for their employees.[281] The minimum level of employer support was expressed as a percentage of the employee's earnings base. The terms "employee" and "employer" were statutorily defined to include, and also extend beyond their ordinary meaning, including relationships that might otherwise be considered contracts for services and therefore had broad application.[282]

In 1994 further changes took effect to simplify the administration of RBLs, the rebate calculation for superannuation pensions and limited deductions for superannuation contributions.[283] Rather than being calculated as a multiple of a person's highest average salary, RBLs were set to a dollar amount of $400,000 for lump sums[284] and $800,000 for qualifying pensions,[285] indexed annually. To the extent that these thresholds were exceeded, the excessive component would be taxed at the recipient's marginal rate of income taxation.[286] A set dollar limit was introduced for deductible employer superannuation contributions on behalf of employees, determined by reference to the employee's age or a standard contribution limit.[287] Similarly, changes were made to the deduction limits available to the self-employed, albeit not completely aligned with the corresponding provisions relating to employees.[288] Due to complexity and anomalous results, the taxing provisions concerning the 15% tax rebate for superannuation pensions within the recipients RBL were also simplified.[289]

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280 *Superannuation Guarantee (Administration) Act 1992* (Cth).

281 *Superannuation Guarantee Charge Act 1992* (Cth).

282 *Superannuation Guarantee (Administration) Act 1992* (Cth) s 12.

283 The changes implemented the statements in John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992). Some measures had a start date of 1 July 1992 and others commenced on 1 July 1994. Refer *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

284 ITAA1936 s 140ZD(1), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

285 ITAA1936 s140ZD(2), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

286 Responsibility for administering RBLs was transferred from ISC to the Commissioner of Taxation. The relevant sections of the OSSA concerning RBL's were repealed and incorporated in to the ITAA1936.

287 ITAA1936 ss 82AAC(2)-(2H), replacing ITAA1936 ss 82AAC(2)-(2A), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

288 ITAA1936 ss 82AAT(2)-(2C), replacing ITAA1936 ss 82AAT(2), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

289 ITAA1936 s 159SM(1), inserted by *Taxation Laws Amendment (Superannuation) Act 1992* (Cth).

Fourth phase – superannuation-related taxation law: 2000 to the present

Taxation reforms continued during the fourth phase of occupational superannuation. Arguably, the most significant of these occurred in 2007 when the Government sought to simplify and streamline Australia's superannuation system. The ambitious objective of Simpler Super was to reduce taxation complexities surrounding superannuation, improve retirement incomes, increase flexibility over how superannuation savings could be drawn down and improve incentives for the public to work and save.[290] After a period of consultation, the existing Pt IX of the ITAA1936 relating to the taxation of superannuation funds was repealed[291] and many of the final decisions implemented through a new Part 3-30 of the ITAA1997.[292]

The Simplified Super reforms revised the rules surrounding deducted and undeducted superannuation contributions, including terminological change to replace those categories with concessional and non-concessional contributions.[293] A concessional contribution cap was set at $50,000 per person per financial year (indexed to average weekly ordinary times earnings (AWOTE) in increments of $5,000),[294] with transitional rules to permit a higher $100,000 cap for those aged 50 years and older until the 2012 income year.[295] A non-concessional cap per person per financial year was set at three times the concessional cap, then being $150,000.[296] The non-concessional cap was subject to a "bring forward" rule providing access to two additional years of non-concessional entitlement.[297] An individual was liable to excess concessional contribution tax on their excess concessional contributions at a rate of 31.5%, with the excess also counting towards the non-concessional contribution cap.[298] An individual was liable for excess non-concessional contributions tax at a rate of 46.5%.[299] These drastic consequences provided a significant incentive for members to comply

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290 Peter Costello, Treasurer, 'A Plan to Simplify and Streamline Superannuation' (Media Release Treasurer, No 42, 9 May 2006).

291 ITAA1936 Pt IX, repealed by *Tax Laws Amendment (Simplified Superannuation) Act 2007* (Cth).

292 ITAA1997 Pt 3-30, inserted by *Tax Laws Amendment (Simplified Superannuation) Act 2007* (Cth).

293 ITAA1997 s 292-25 (definition of "concessional contributions"); ITAA1997 s 292-90 (definition of "non-concessional contributions").

294 ITAA1997 ss 292-20(2), 960-285.

295 *Income Tax (Transitional Provisions) Act 1997* (Cth) s 292-20.

296 ITAA1997 s 292-85(2). A further transitional measure was available to those eligible to contribute to superannuation increasing the non-concessional cap for the period between 10 May 2006 and 30 June 2007 to $1 million. Refer *Income Tax (Transitional Provisions) Act 1997* (Cth) ss 292-80(1), (3)(c).

297 ITAA1997 s 292-85(4).

298 ITAA1997 s 292-15, inserted by *Superannuation (Excess Concessional Contributions Tax) Act 2007* (Cth).

299 ITAA1997 292-80, inserted by *Superannuation (Excess Non-concessional Contributions Tax) Act 2007* (Cth).

with the contribution thresholds.[300] On that basis, the RBL arrangements (limiting the benefits a person could receive on a concessionally taxed basis) became redundant and were repealed.[301]

Complementing these changes, the historic disparity between the level of taxation concessions for contributions to a superannuation fund by employed persons and the self-employed was finally removed.[302] Both employers and the self-employed became entitled to claim a tax deduction for all contributions to a complying superannuation fund on behalf of employees or themselves until the age of 75 years.[303] The test surrounding the eligibility of an individual to claim personal superannuation contributions was also simplified, broadly requiring 10% or less of a person's assessable income and reportable fringe benefits to be attributable to employment as an employee.[304]

The taxation of benefit payments was modified as part of the Simpler Super reforms, with superannuation pensions and lump sums paid from a taxed source to an individual aged 60 years and over becoming tax free.[305] In contrast, the taxation of benefit payments to an individual aged under 60 years, although somewhat simplified, remained broadly consistent with the existing arrangements. The composition of a superannuation benefit was streamlined into two components, being a tax free component and a taxable component.[306] The tax free component is non-assessable non-exempt income, comprising of a contributions segment and a crystallised segment.[307] The taxable component is the total value of a superannuation benefit less the tax-free component and consists of two elements, being amounts that have been taxed or untaxed in the superannuation fund.[308] The untaxed element arises in Government sector schemes or partially unfunded schemes where no contributions and earnings tax has been

300 The tax burden would potentially reach 93% where both contribution caps were exceeded, comprising 15% on the assessable contribution to the fund, 31.5% excess concessional contributions tax and 46.5% excess non-concessional contributions tax.
301 RBL arrangements were repealed by *Superannuation Legislation Amendment (Simplification) Act 2007* (Cth).
302 ITAA1936 ss 82AAT, 82AAC, repealed by *Superannuation Legislation Amendment (Simplification) Act 2007* (Cth), containing the former aged-based contribution limits for personal and employer contributions.
303 ITAA1997 ss 290-80, 290-165.
304 ITAA1997 s 290-160.
305 ITAA1997 s 301-10.
306 ITAA1997 s 307-120.
307 Refer ITAA1997 s 307-220 for explanation of the contributions segment. It includes all contributions after 30 June 2007 that have not been included in the assessable income of the superannuation fund. Refer ITAA1997 s 307-225 for explanation of the crystallised segment. It includes the existing components that are consolidated into the tax free component, including undeducted contributions, the pre-July 1983 component, the CGT exempt component, the concessional component and the post-June 1994 invalidity component. It is calculated assuming an ETP representing the full value of the interest was paid just prior to 1 July 2007.
308 ITAA1997 ss 307-215, 307-275.

paid.[309] The taxed element is where tax has been paid by the superannuation fund, typically including deductible personal or employer contributions and earnings on those amounts.[310]

Shortly after Simpler Super the Government's focus returned to restricting the concessional contribution caps, with a reduction from $50,000 to $25,000 for the 2010 financial year.[311] The indexation of the cap to AWOTE was continued for subsequent years.[312] The transitional concessional cap for those aged 50 years or older was similarly halved from $100,000 to $50,000 for the 2010 to 2012 financial years and remained unindexed.[313] The new concessional limits were intended to ensure that superannuation taxation concessions were being targeted appropriately.[314] No substantive change was made to the non-concessional contribution cap other than its calculation methodology, becoming six times the revised concessional contribution cap to maintain the existing limit.[315]

Sustainability measures were introduced 2013 to reduce the attractiveness to high income earners of making concessional superannuation contributions.[316] A Division 293 tax liability was imposed at a rate of 15% where such individual's had taxable contributions for the income year.[317] Taxable contributions arise where an individual's income for surcharge purposes less reportable superannuation contributions plus low tax contributions exceeded $300,000.[318] The amount of the taxable contribution is the lesser of the low tax contributions or the amount of the excess.[319] For this purpose, low rate contributions typically include concessional contributions less any excess concessional contributions for that year.[320]

309 ITAA1997 ss 307-280, 307-295. This component is not relevant to the SMSF addressed in this thesis.

310 ITAA1997 307-275(2).

311 ITAA1997 s 292-20(2)(c), inserted by *Tax Law Amendment (2009 Budget Measures No. 1) Act 2009* (Cth).

312 ITAA1997 s 292-20(2)(d), inserted by *Tax Law Amendment (2009 Budget Measures No. 1) Act 2009* (Cth).

313 *Income Tax Transitional Provisions) Act 1997* (Cth) ss 292-20(2)(c)-(e), inserted by *Tax Law Amendment (2009 Budget Measures No. 1) Act 2009* (Cth).

314 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No.1) Bill 2009 (Cth) 27-28.

315 ITAA1997 s 292-85(2)(c), inserted by *Tax Law Amendment (2009 Budget Measures No. 1) Act 2009* (Cth).

316 ITAA1997 Division 293, inserted by *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013* (Cth).

317 ITAA1997 s 293-15; *Superannuation (Sustaining the Superannuation Contribution Concession) Imposition Act 2013* (Cth).

318 ITAA1997 s 293-20.

319 ITAA1997 s 293-20(1).

320 ITAA s 293-25.

Although the resulting liability is assessed to the member,[321] it may be paid subject to a release authority from the individual's accumulation interest in a superannuation fund.[322]

In 2014 further reforms were made to reduce the inequities and severity of the taxes on excess concessional and non-concessional contributions.[323] The tax on excess concessional contributions was repealed, with the excess instead being included in the individual's assessable income[324] to be taxed at their marginal rate of income taxation, subject to a 15% tax offset.[325] This revised approach overcame the deficiencies with the earlier flat rate of 31.5%, which represented a relatively higher penalty for individuals on lower marginal rates of income taxation in comparison to those on higher rates. Individuals could also elect to release up to 85% of their excess concessional contributions for a year, which might assist them in paying their tax liability.[326] An excess concessional contribution charge captures the timing delay in the individual paying the tax due.[327]

From the 2015 income year reforms were also made to make the taxation treatment of excess non-concessional contributions fairer. The FCT must now make a determination in respect of an individual that has made excess non-concessional contributions, stating the amount of the excess, the associated earnings on those contributions and the total release amount.[328] The individual receiving the determination can then choose to release the amount on the notice (being their excess non-concessional contributions plus 85% of the associated earnings on that amount).[329] The full earnings amount would then be included in the individual's

[321] ITAA1997 ss 293-65(1), 293-70(1).

[322] Division 135 Schedule 1 *Taxation Administration Act 1953* (Cth), inserted by *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013* (Cth).

[323] An earlier change had given individuals with excess concessional contributions of less than $10,000 the option of having that excess refunded and assessed at their marginal rate of income tax with an offset of 15% (reflecting the tax paid by the superannuation fund on the contribution). Refer ITAA1997 s 292-467, inserted by *Tax and Superannuation Laws Amendment (2012 Measures No.1) Act 2012* (Cth).

[324] ITAA1997 s 291-15(a), inserted by *Tax Laws Amendment (Fairer Taxation of Excess Concessional Contributions) Act 2013* (Cth).

[325] ITAA1997 s 291-15(b), inserted by *Tax Laws Amendment (Fairer Taxation of Excess Concessional Contributions) Act 2013* (Cth). The offset reflects the 15% tax paid on the excess contribution by the superannuation fund.

[326] *Tax Administration Act 1953* (Cth) Sch 1 s 96-5, inserted by *Tax Laws Amendment (Fairer Taxation of Excess Concessional Contributions) Act 2013* (Cth).

[327] *Tax Administration Act 1953* (Cth) Sch 1 Div 95, inserted by *Tax Laws Amendment (Fairer Taxation of Excess Concessional Contributions) Act 2013* (Cth).

[328] *Tax Administration Act 1953* (Cth) Sch 1 s 97-25, inserted by *Tax and Superannuation Laws Amendment (2014 Measures No.7) Act 2015* (Cth).

[329] *Tax Administration Act 1953* (Cth) Sch 1 s 96-7, inserted by *Tax and Superannuation Laws Amendment (2014 Measures No.7) Act 2015* (Cth).

assessable income to be taxed at their marginal rate of income taxation, subject to a 15% tax offset.[330]

Further taxation reforms to make superannuation fiscally sustainable and fairer were enacted to implement announcements in the Governments 2016-17 Budget,[331] with commencement dates varied though starting in the 2017 income year.[332] A significant change was the reduction in the concessional superannuation contribution cap to $25,000, and reduction of the non-concessional superannuation contribution cap to $100,000.[333] A limitation on the amount that an individual can transfer to retirement phase accounts of $1.6 million (transfer balance cap) was also introduced.[334] Accordingly, an individual with more than this threshold in pension phase would need to withdraw the excess or transfer the excess to an accumulation phase account. The taxation exemption on superannuation fund earnings that support a transition to retirement pension was also removed.[335]

Conclusion – taxation concessions to encourage participation

The history of superannuation taxation law reveals a continuum of change, narrowing from its early regulatory and revenue purposes to solely focus on the latter objective. The extent of change has heightened over time and coincides with increasing participation, the emergence of inappropriate activities taking advantage of superannuation fund tax concessions, the endorsement of superannuation as a component of retirement income policy and growing fiscal constraints. Reflecting the significance of these variables, the role and extent of support from taxation measures to encourage superannuation has also changed in the passage of time to be reflected in amendments to the Tax Acts.

Unsurprisingly, with legislative amendments building on earlier amendments it has proved difficult to avoid taxation law complexity, despite some more recent effort at simplification. In addition, where taxing rules change so frequently, confusion invariably arises even with more straightforward provisions to determine which set of requirements or transitional measures have application to a particular income year. This situation has the propensity to

330 ITAA1997 ss 292-25, 292-30, inserted by *Tax and Superannuation Laws Amendment (2014 Measures No.7) Act 2015* (Cth).

331 Commonwealth of Australia, *Budget 2016-17, Budget Measures, Budget Paper No.2* (2016) 24-30.

332 *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).

333 ITAA1997 ss 291-20(2)(a), 292-85(2), inserted by *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).

334 ITAA1997 Subdivision 294-B, inserted by *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).

335 ITAA1997 s 307-80(3), inserted by *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).

reduce certainty and confidence in the tax incentives available for participants in superannuation. Nonetheless, the continued ability to save for retirement in a tax concessional fund, claim taxation deductions for concessional contributions and receive concessionally taxed benefit payments means taxation remains important for the continued existence and success of superannuation.

As efforts are made to clarify the role of superannuation, it is likely that taxation law will respond with further change.[336] Particularly in light of more recent budgetary constraints, it is reasonable to suggest that taxation incentives for superannuation will continue to reduce in the future. However, history has also revealed the difficulties in adopting any other alternative, such as universal compulsory funded schemes. Given its entrenchment and the amount of savings already invested in superannuation, the taxation encouragement for participation in superannuation shall continue to play an important role. The conclusion is significant for this thesis, given that average SMSF member account balances are higher than those in other categories of superannuation fund,[337] and consequently attract a higher amount of taxation support.

2.4.3 Superannuation and regulation

Background

The preceding discussion has revealed that taxation measures had a dual revenue and regulatory role during the early stages of their development. These early regulatory constraints on superannuation fund activity were not overtly prudential and were focussed on preventing abuse of the available taxation concessions enjoyed by a privileged section of the population. That approach accords with the view that such a narrow range of participants would be reasonably capable of making independent enquiries and taking appropriate action to ensure their superannuation was secure. However, this position was not fixed and, as superannuation coverage expanded, taxation regulation showed greater concern for the safety

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[336] In relation to recent efforts to identify the purpose of superannuation, refer Superannuation (Objective) Bill 2016 (Cth).

[337] For example, as at 30 June 2015 the average account balance for APRA-regulated superannuation fund members was $45,924, while the average for SMSF members was $589,636. Australian Prudential Regulation Authority, *APRA releases annual superannuation statistics for June 2015* (2016) <http://www.apra.gov.au/MediaReleases/Pages/16_03.aspx>; Australian Taxation Office, *Annual SMSF population analysis tables* (2016) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-statistical-report-June-2016/?anchor=Membershipsizes#Membershipsizes>.

of member interests.[338] The change in direction responded to the inability of a broadening membership base to exert influence over superannuation fund activities.

Yet, even at this early stage taxation laws did not provide the sole source of constraint on superannuation fund activity, with general law obligations of trustees persisting throughout the history of the superannuation. Accordingly, members obtained some security in relation to the actions of superannuation fund trustees from the application of trust law. This follows from the fact that, statutory schemes aside,[339] superannuation funds have existed and continue to operate through a trust structure. The trustee and beneficiary relationship also subjects trustees to fiduciary obligations, meaning that trustees must not place themselves in a position of conflict with their duties as trustee or make an unauthorised profit from the trust.[340] While these obligations could be aptly described as prudential or paternalistic and contribute to historical regulatory discussion, their consideration is deferred to Chapter 4 where they receive particular consideration in the context of the SMSF.

Beyond the early regulatory role by the various Tax Acts and general law obligations, further sources of statutory intervention have emerged to constrain superannuation fund activity. They have shared a singular focus to improve the safety of member interests and are accurately described as prudential regulation. The initial step in this process was the enactment of the OSSA and accompanying OSSR. These measures were subsequently superseded by the SISA regime, which brought improvements to the range of consequences for inappropriate trustee conduct beyond the drastic step of making a superannuation fund non-compliant. Consistent with the approach to superannuation fund taxation, some historical analysis of prudential legislative constraints on superannuation fund activity provides useful context, reiterating the importance of restrictions to assure that superannuation savings are safe.

The extent of this analysis is not as comprehensive as the preceding analysis of the Tax Acts. The reasoning for this is threefold. First, as a matter of fact the extent of change to the

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338 For example, ITAA1936 121C was inserted by *Taxation Laws Amendment Act (No 2) 1985* (Cth) to make the income tax exemption for ss 23F and 23FB funds conditional on meeting taxation law in-house asset investment restrictions. ITAA1936 s 121C(5) set the limit of investment by such funds (including loans) in the sponsoring employer at 10% of the cost of all assets in the fund. The rule reduced the risk that superannuation fund assets would be depleted due the unsuccessful business operations of the employer-sponsor.

339 For example, a retirement saving account is a non-trust superannuation structure that operates pursuant to the *Retirement Savings Accounts Act 1997* (Cth). It is offered by certain financial institutions and life insurance companies to provide superannuation benefits upon death, retirement and in other limited circumstances.

340 *Breen v Williams* (1996) 186 CLR 71, 113 (Gaudron and McHugh JJ).

prudential arrangements for regulated superannuation is limited in comparison to the endless stream of amendments endured by taxation laws. Secondly, many areas of prudential regulation have by exception had no or limited application to the SMSF, and in that context a comprehensive analysis of all restrictions is of limited benefit. Thirdly, the conceptualisation of the SMSF developed in this thesis is one that has little need for prudential regulation, replaced by constraints that recognise the substance of the arrangement and the need to limit SMSF participant behaviour. In light of these matters a broad historical overview suffices, subject to the detailed consideration of the SISA covenants in Chapter 4 that demonstrates their unsuitability for the SMSF.

The OSSA and OSSR

The OSSA regime had general application from 1 July 1986 and saw the ITAA1936 begin to relinquish its regulatory role to focus solely on revenue objectives.[341] The continued eligibility of a s 23F, s 23FB or s 23(ja) fund for a tax concessional treatment became dependent upon the satisfaction of certain superannuation fund conditions specified in the OSSA.[342] Upon enactment these conditions can be summarised as follows:

(a) That it was a superannuation fund at all times during the year of income when it was in existence;[343]
(b) That it complied with the operating standards prescribed in the OSSR for the purposes of subsection 7(1) of the OSSA;[344]
(c) That it complied with requests by the ISC for information and production of documents;[345]
(d) That as an interim measure (pending relocation of existing superannuation-related provisions in the ITAA1936 to the OSSA or OSSR) that it complied with the requirements of s 23(ja), s23F or S23FB of the ITAA1936 as the case required and thus would be fully exempt from taxation under those provisions.[346]

For the purpose of the second requirement, s 7(1) of the OSSA provided that regulations may prescribe standards applicable to the operation of superannuation funds. Whilst not limiting the range of matters that may be covered, s 7(2) then sets out a range of issues that those

341 Refer section 2.4.2 of this thesis for discussion of taxation history.
342 OSSA s 5.
343 OSSA s 5(2)(a).
344 OSSA s 5(2)(b).
345 OSSA s 5(2)(c).
346 Accordingly, an s 23F or s 23FB fund whose tax exemption was reduced due to s 121C of the ITAA1936 (in-house asset restrictions) would be ineligible.

standards might cover, including: contributions, vesting, preservation, payment and portability of benefits, investment of assets, trustee composition, financial reports and disclosure of information. The absence of any detail in the OSSA on these broad heading areas was consistent with the view that formation of the detailed standards in regulations would provide increased flexibility and facilitate maximum co-operation between industry and the Government on supervisory arrangements.[347]

Having regard to these matters, ISC would issue a notice in writing to the trustees of a superannuation fund stating whether or not the fund complied with the OSSA regulatory conditions for an income year, being the prerequisite for income tax exemption. The issue of such a notice would depend upon the provision of a return addressing the fund's satisfaction of the superannuation fund conditions, a trustee certificate, an auditor's certificate and payment of prescribed fees.[348] The ISC also had discretion to treat a superannuation fund as satisfying the OSSA regulatory conditions where they were in fact not satisfied and proceed to issue a notice of compliance on that basis.[349]

In addressing the circumstances of a particular superannuation fund and reaching a decision on whether the fund conditions had or should be treated as being satisfied, the ISC had regard to the more detailed standards in the OSSR. Although substantially expanding on the matters set out in s 7(2) of the OSSA, initially the OSSR were not particularly voluminous. It did, however, reflect the Government's focus on ensuring that superannuation savings were used for providing retirement incomes and not inappropriately for current day benefits. Upon commencement the main regulations applicable to a superannuation fund could be summarised as follows:

Preserve of member benefits

Regulation 5	Restricts the exercise of a lien over benefits by an employer or contributor to the fund, nor enlarge the scope of a lien existing prior to the regulations commencement.
Regulation 6	Prescribes vesting standards applicable to funds in operation on 30 June 1986.
Regulation 7	Prescribes vesting standards applicable to funds established on or after 1 July 1986.

347 Clyde Holding, Minister for Employment Services and Youth Affairs and Minister Assisting the Treasurer, 'Occupational Superannuation Standards Bill 1987' (Second Reading Speech delivered at the House of Representatives, Canberra, 18 September 1987).
348 OSSA s 12 (as enacted).
349 OSSA s 13 (as enacted).

Regulation 8	Provides for a member's total benefit resulting directly or indirectly from employer contributions in accordance with a prescribed agreement or award to be vested in the members on the date on which it accrues.
Regulation 9	Provides for preservation of amounts vested in accordance with Regulation 8 or transferred to a member in accordance with Regulation 11.
Regulation 10	Provides for preservation of new or improvements in employer-financed benefits vested in a member, which result from arrangements or agreements entered into on or after 22 December 1986.
Regulation 11	Prescribes standards for preservation and portability of member benefits.
Regulation 12	Prescribes that preservation standards do not apply where the total amount of the benefit is less than a de minimus $500.
Guide fund decision making	
Regulation 13	Requires equal member and employer representatives to be appointed to trustee boards for large funds (those having 200 or more members).
Regulation 14	Requires not less than two thirds of trustees to have voted in favour of a decision for trustees of large funds.
Regulation 15	Requires equal member and employer representatives to be appointed to trustee boards for small funds (those having less than 200 members) or for one or more persons agreed by members and their employers to be the trustee(s) of the fund.
Restrict Investment activity	
Regulation 16	Prescribes standards for the investment of fund assets, including that investments are to be made on an arm's length basis and subject to transitional arrangements a prohibition on lending money to members or borrowing money from others.
Reporting and disclosure obligations	
Regulation 17	Prescribes standards for financial reports, actuarial reports and information to be provided to each member.
Regulation 18	Requires that by 30 June 1990 particular OSSR standards shall be included in the trust deed of a superannuation fund, or otherwise provide that those requirements are deemed to be so included.

Collectively these standards contributed to an improvement in the protection of member entitlements and brought increased rigour surrounding trustee decision making and accountability. The way in which this was achieved was through the Regulation 18, which required the operating standards to be included in the content of the superannuation funds trust deed. The OSSA did not, however, include a provision to penalise trustees for non-compliance, other than the extreme outcome of withdrawing the superannuation fund's tax concessional status. This followed from the fact that the OSSA regime relied on the taxation power in the Constitution for its legal efficacy, raising doubt whether other types of penalties would fall within the power or be subject to challenge.

Reforms to OSSA and OSSR

Given the approach to include the regulatory detail of the operating standards for superannuation funds in the OSSR, the OSSA did not undergo significant legislative change in the relatively short period prior to the creation of the SISA regime. Most changes were administrative in nature, such as changes to supervisory levies[350] and new arrangements for the administration of reasonable benefit limits.[351] In relation to the latter, amendments to the OSSA enabled regulations to prescribe the method for determining reasonable benefit limits and whether a benefit was in excess of those limits.[352] The change was of some significance, in that it facilitated the transfer of power for determining the RBLs from the ISC to Government, whilst the ISC continued to administer those limits.

In contrast to the limited reforms to the OSSA, significant amendment did occur to the OSSR. Once again a number of these changes were administrative, such as providing the necessary forms for an approved auditor to certify an audit report and supervisory levy arrangements.[353] Focussing on the more substantive changes, Regulation 9 was amended in 1989 to extend preservation standards to those members who were eligible persons under Subdivision AB in Division 3 of Part III of the ITAA1936, namely self-employed persons.[354] During 1990 a number of amendments refined the vesting and preservation standards, along with changes to standards on financial reporting and disclosure of information to members.[355] Reflective of changes to the OSSA, new OSSR regulations were also inserted with effect from 1 July 1990 to guide the calculation of member RBLs and excessive benefits.[356]

Coinciding with the introduction of the SGC in 1992, changes to the OSSR were necessary to ensure superannuation funds could receive superannuation guarantee contributions, including

[350] *Occupational Superannuation Laws Amendment Act 1991* (Cth).

[351] *Occupational Superannuation (Reasonable Benefit Limits) Amendment Act 1990* (Cth).

[352] Explanatory Memorandum, Occupational Superannuation (Reasonable Benefit Limits) Amendment Bill 1990 (Cth) 1.

[353] *Occupational Superannuation Standards Regulations (Amendment) 255/1988* (Cth); *Occupational Superannuation Standards Regulations (Amendment) 155/1991* (Cth).

[354] *Occupational Superannuation Standards Regulations (Amendment) 24/1989* (Cth).

[355] *Occupational Superannuation Standards Regulations (Amendment) 150/1990* (Cth); *Occupational Superannuation Standards Regulations (Amendment) 185/1990* (Cth).

[356] *Occupational Superannuation Standards Regulations (Amendment) 202/1990* (Cth). Refer amendment in relation to RBLs followed in *Occupational Superannuation Standards Regulations (Amendment) 58/1991* (Cth) and *Occupational Superannuation Standards Regulations (Amendment) 458/1991* (Cth).

the SG shortfall component in respect of a member. Changes were made to ensure that SG contributions were not prevented due to existing age-based restrictions and to ensure that benefits arising from SG contributions vested in the member on the day of the accrual and to address information disclosure between employer-sponsors and the ISC.[357] In addition, further changes addressed superannuation fund reporting, building on existing requirements to improve disclosures surrounding account information, the financial condition and investment objectives of the fund.[358]

Taxation-related consequential amendments were made to the OSSR in 1992, following legislative amendments that were aimed at simplifying the taxation of superannuation.[359] In particular, the OSSR were amended to prescribe the minimum standards for pensions and annuities that would enable those benefits to be taxed concessionally.[360] Significantly, this introduced a change in approach whereby allocated pensions could meet the required standard, despite their payment rate and basis for variation not being fixed at commencement.[361] Further amendment was made to ensure that the OSSR were consistent with the OSSA definition a superannuation fund, which had been broadened to permit retired persons to transfer benefits to a superannuation fund.[362]

Although close to the commencement of the SISR, two further significant changes were made to the OSSR in 1993. The first of these was to introduce a new regulation to prohibit the purchase of new in-house assets, where the level of those assets already exceeded 5% of the superannuation fund's total assets by market value or where such a purchase would cause that threshold to be exceeded.[363] The second amendment addressed a tax avoidance concern and was targeted at preventing superannuation funds from giving financial assistance to, or acquiring assets from, members or their relatives.[364] Given the importance of these changes, it

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[357] *Occupational Superannuation Standards Regulations (Amendment) 223/1992* (Cth).

[358] *Occupational Superannuation Standards Regulations (Amendment) 224/1992* (Cth). Subsequently, the *Occupational Superannuation Standards Regulations (Amendment) 387/1992* (Cth) introduced transitional arrangements due to the difficulty experienced of funds in meeting the new reporting requirements.

[359] Refer *Taxation Laws Amendment (Superannuation) Act 1992* (Cth); John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992).

[360] *Occupational Superannuation Standards Regulations (Amendment) 463/1992* (Cth).

[361] *Occupational Superannuation Standards Regulations (Amendment) 463/1992* (Cth).

[362] *Occupational Superannuation Standards Regulations (Amendment) 463/1992* (Cth).

[363] OSSR reg 16B, inserted by *Occupational Superannuation Standards Regulations (Amendment) 14/1993* (Cth).

[364] *Occupational Superannuation Standards Regulations (Amendment)* 189/1993 (Cth).

was considered that they should have immediate effect through the OSSR, rather than wait until commencement of the SISA regime.[365]

The SISA and SISR

Consistent with recommendations in 1992 by the Senate Select Committee on Superannuation[366] and the Australian Law Reform Commission,[367] the Government committed itself to substantially enhance the prudential regulation of superannuation funds to apply progressively from 1 July 1993.[368] This included the need to draw upon other heads of constitutional power beyond taxation, namely the corporations and pension power, to more effectively enforce a stronger prudential regime.[369] In principle support was also given to the legislative codification of trust law principles.[370] These matters were set out in the Government statement, Strengthening Super Security[371] (Strengthening Super), which explained the prudential arrangements for superannuation funds. It also reiterated the view that no investment was more special than superannuation or critical in providing retirement income for an increasingly ageing population.[372]

The SISA regime was subsequently introduced in 1993 to prudentially regulate superannuation in Australia.[373] The objective was to increase protection of superannuation savings and promote a more efficient superannuation industry, while avoiding unreasonable supervisory and compliance costs.[374] Trustees retained prime responsibility for the viability and prudent operation of superannuation funds, with the SISA enhancing their role through clearly defined duties and subjecting them to legislative sanction for failure to properly carry

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[365] Explanatory Statement, Occupational Superannuation Standards Regulations (Amendment) 189/1993 (Cth) 1.

[366] Senate Select Committee on Superannuation, Parliament of the Commonwealth of Australia, *Safeguarding Super* (1992).

[367] Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992).

[368] John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992) 30.

[369] John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992) 30.

[370] John Dawkins, Treasurer, 'Security in retirement, planning for tomorrow today' (1992) 31.

[371] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992).

[372] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) iii.

[373] The SISA was one of seven Acts enacted to regulate superannuation under the new regime. The other Acts included: *Occupational Superannuation Standards Amendment Act 1993* (Cth); *Superannuation (Resolution of Complaints) Act 1993* (Cth); *Superannuation (Financial Assistance Funding) Levy Act 1993* (Cth); *Superannuation (Rolled-Over Benefits) Levy Act 1993* (Cth); *Superannuation Supervisory Levy Amendment Act 1993* (Cth); *Superannuation Industry (Supervision) Consequential Amendments Act 1993* (Cth).

[374] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 3.

out their responsibilities.[375] Taxation incentives remained critical, though accessible only where the superannuation fund brought itself within the corporations or pensions power in the Constitution. In accepting to do this, superannuation fund trustees voluntarily accepted their exposure to penalties for breaches of the SISA based on those powers, overcoming deficiencies with the earlier OSSA position.

Initially, the SISA operated in conjunction with the OSSR, prior to the introduction of the SISR in 1994. Unsurprising, many of the prudential requirements introduced by the new regime aligned with established principles and standards. Yet the SISA regime was also more comprehensive and sought to build upon the existing levels of protection for superannuation fund members. The core components of the new package included:[376]

- Effective supervisory arrangements involving direct enforcement powers by the ISC in relation to prudential requirements and obligations of funds and trustees.
- Adequate legislative sanctions for trustees in relation to the proper performance of fiduciary responsibilities and increased accountability to members.
- Clear delineation of the basic duties and responsibilities of trustees.
- Ensuring that trustees and investments managers are suitable to act as fund trustees and to manage fund monies.
- Provision of financial assistance to funds that have suffered loss due to fraudulent conduct or theft.
- Mechanisms to deal with benefits in employer-sponsored funds in respect of members that have left employment, who are lost or unclaimed benefits.
- Provision for equal member and employer representation.
- Disclosure obligations for superannuation fund auditors and actuaries.
- Rules concerning invitations and offers to subscribe for interests in, and disclosure by, public offer superannuation funds, approved deposit funds and pooled superannuation trusts.

Beyond these broad elements, the SISA introduced a number of key provisions that justify particular attention for application to a regulated superannuation fund. Foremost, the SISA contained a sole purpose test to protect member's interests by acting as a catch-all restriction, that a superannuation fund must be conducted for core retirement income purposes or such purposes and other ancillary purposes.[377] A further restriction prohibited a trustee from

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[375] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 1.
[376] Explanatory Memorandum, Superannuation Industry (Supervision) Bill 1993 (Cth) 1-2.
[377] SISA s 62.

lending money of the superannuation fund or providing financial assistance using the resources of the fund to members or their relatives.[378] Another constraint prohibited the acquisition of assets by a superannuation fund from related parties, with exceptions for listed securities or business real property (BRP) acquired at market value.[379] Consistent with earlier regulations, a trustee was restricted from investing no more than 5% of the fund's assets in in-house assets.[380]

Reforms to SISA and SISR

Although less prolific than the amendments to taxation law, the process of enhancement and refining the SISA commenced shortly after its enactment.[381] While the general principles and key provisions that have been identified continued to have application, the detail and complexity of the SISA and SISR slowly evolved. Importantly, many changes had no application to the SMSF or its predecessor the ESF, given the regulatory exceptions for those vehicles. On that basis, a detailed historical regulatory analysis is less relevant than the history of changes to taxation law which had more universal application. Nonetheless, it is worthwhile for contextual purposes to mention some of the more significant reviews of the SISA and the Government's legislative responses to their recommendations.

In 1997 the Wallis Report made a range of recommendations to improve the Australian financial system's regulatory arrangements.[382] As previously mentioned, two significant responses following these recommendations were the transfer of administration of the SISA from the ISC to APRA,[383] and later the transfer to the ATO of administration for ESFs and their re-naming to SMSFs.[384] Importantly, given the subject matter of this thesis, the latter change reflected an acceptance that these types of small superannuation funds should not be subjected to the prudential requirements of APRA-regulated funds as a precondition to concessional tax treatment. They did, however, remain subject to the SISA, with a

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378 SISA s 65.
379 SISA s 66.
380 SISA ss 71, 82, 83.
381 Refer *Superannuation Industry (Supervision) Legislation Amendment Act 1994* (Cth); *Superannuation Industry (Supervision) Legislation Amendment Act 1995* (Cth).
382 Wallis Report 31-73.
383 APRA was established by the *Australian Prudential Regulatory Authority Act 1998* (Cth). The *Insurance and Superannuation Commissioner Act 1987* (Cth) was repealed by the *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998* (Cth). ASIC was given responsibility for market integrity and consumer protection aspects.
384 *Superannuation Legislation Amendment Act (No. 3) 1999* (Cth).

continuation of relevant exceptions from some regulatory requirements to modify the "one-size fits all" approach, and subjection to new administrative levy arrangements.[385]

In 1999 the application of superannuation investments rules in SISA were broadened.[386] Most significantly the prohibition on a superannuation fund intentionally acquiring an asset from a fund member (or a relative thereof) was extended to acquisitions from a related party.[387] The expression "related party" was expansively defined to mean a member of the fund or standard employer-sponsor of the fund or a Part 8 associate of either entity.[388] The exception for trustees to acquire assets at market value from a member of the fund (or a relative thereof) for listed securities and BRP (ESFs only) persisted but was consistently broadened to acquisitions from a related party.[389] In addition, increased flexibility was given to ESFs, by increasing the percentage of their assets that could be used to acquire BRP from a related party of the fund from 40% to 100%.[390] The increase was considered an enhancement for small business owners to use superannuation savings to invest in their own business premises.[391]

Following recommendations contained in the 2001 Inquiry Report on the SISA by the Productivity Commission[392] (PC Report) and the 2003 Report of the Superannuation Working Group on the safety of superannuation[393] (SWG Report), the SISA was amended to build confidence in the superannuation system.[394] The changes were designed to modernise the prudential regime and make it more responsive to risk.[395] They included new licensing requirements for APRA-regulated trustees to operate a Registrable Superannuation Entity (RSE).[396] A range of conditions were imposed on RSE licences[397] and failure to comply would potentially result in cancellation of their licence.[398] Further amendments provided for the registration of RSEs,[399] which provided a mechanism through which APRA could

385 *Superannuation Legislation Amendment Act (No. 3) 1999* (Cth).
386 *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).
387 SISA s 66(1), amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).
388 SISA s 10(1) (definition of "related party"), inserted by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).
389 SISA s 66(2), amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).
390 SISA s 66(2)(b), amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).
391 Rod Kemp, Assistant Treasurer, 'New Superannuation Investment Rules' (Press Release, No 19, 22 April 1999) 3.
392 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation*, Report No. 18 (2001).
393 Superannuation Working Group, *Report of the Superannuation Working Group on Options for Improving the Safety of Superannuation* (2002).
394 *Superannuation Safety Amendment Act 2004* (Cth).
395 Explanatory Memorandum, Superannuation Safety Amendment Bill 2003 (Cth) 9-10.
396 SISA Pt 2A.
397 SISA Pt 2A Divs 5-6.
398 SISA Pt 2A Div 7.
399 SISA Pt 2B.

systematically obtain information about the superannuation entities that it regulates. Failure to register could also result in the RSE licensee breaching a licence condition and lead to a possible loss of their licence. Neither of the licencing or registration requirements applied to the SMSF, being administered by the ATO rather that APRA.

While further amendment to the SISA occurred following the 2007 Simpler Super initiative, these were limited consequential matters required to implement taxation reforms. However, the level reform significantly increased, following the 2010 Cooper Report, with the Government's release of its 2013 Stronger Super package of reforms. The amendments to the SISA included the replacement of the existing trustee covenants to increase the standard of care, skill and diligence imposed on the trustees of a RSE to that of a prudent superannuation trustee.[400] They also introduced new trustee obligations in relation to the MySuper product.[401] Consistent with the trend of many regulatory changes, the duties of SMSF trustees were largely immune from these reforms, apart from relocation and organisation of the trustee covenants.[402]

The accumulation of changes to the SISA and supporting SISR has produced complexity, with many transitional and grandfathering provisions adding to their volume. While the headings used to summarise the OSSR could broadly explain the current position, the material covered by the SISA and SISR is more extensive and has been modernised, making it difficult to accurately divide on that basis.[403] To provide some degree of overview to the current consolidated position, the parts of the SISA and SISR now in force are summarised below:

SISA

Part 1-2	Preliminary, interpretation and approvals
Part 3	Operating standards for superannuation entities
Part 4-5	Accounts, reporting and notices about complying fund status
Part 6	Governing rules of superannuation entities
Part 7-8	Restrictions applying only to regulated superannuation funds
Part 9	Equal representation of employers and member for employer-sponsored funds
Part 12	Duties of trustees and investment managers of superannuation entities

400 SISA s 52, replaced and substituted by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
401 SISA ss 29VN-VO, inserted by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
402 SISA ss 52B-C, inserted by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
403 The contents table of the SISA alone occupies 29 pages of the Act.

Part 14	Other provisions applying to superannuation entities
Part 15	Standards for trustees, custodians and investment managers of superannuation entities
Part 16	Actuaries and auditors of superannuation entities
Part 17	Suspension or removal of the trustee of a superannuation entity
Part 18	Amalgamation of funds
Part 19	Provisions relating to superannuation interests in public offer entities
Part 20	Administrative directions and penalties for SMSF related contraventions
Part 21-22	Contravention of civil penalty provisions and infringement notices
Part 23	Financial assistance to certain funds
Part 24	Eligible rollover funds and transitional provisions
Part 25	Monitoring, investigation and tax file numbers
Part 26-28	Offences, court powers and proceedings
Part 29	Exemptions, modifications and information
Part 30-34	Miscellaneous and additional transitional provisions

SISR

Part 1-3	Preliminary and interpretative matters
Part 4	Management and trusteeship of superannuation entities
Part 5	Benefit protection standards
Part 6	Payment standards
Part 7	Contribution and benefit accrual standards (regulated superannuation funds)
Part 8	Financial reporting
Part 9	Financial management of funds
Part 10	Eligible rollover funds
Part 11	Information to be given to the Regulator and related matters
Part 12-14	Miscellaneous and transitional matters

Conclusion – prudential constraints

Although continuing to rely on the taxation power in the Constitution, the OSSA regime marked an important step in creating a demarcation between the role of the Tax Acts in providing a concessional taxation treatment and the operating standards with which superannuation funds needed to comply to access those concessions. The creation of the ISC reflected the importance of having a separate body to supervise compliance with the new regulatory standards, rather than leaving that to the ATO alongside its revenue collection priorities. However, OSSA's reliance on the taxation power for legal efficacy meant that compliance with the standards was enforced indirectly by the threat or actual removal of a superannuation funds complying status and accompanying tax concessions. This inflexibility proved to be its undoing and justified the creation of the SISA regime, which based on other constitutional powers was better placed to address trustee contraventions.

The SISA regime introduced more effective supervisory arrangements involving direct enforcement of prudential requirements and obligations of superannuation funds and their trustees based on the corporations and pensions powers in the Constitution. A clear delineation of the basic duties and responsibilities of trustees, investment restrictions and information disclosure obligations underscored the policy objective of enhancing the safety of superannuation. This desire to make superannuation safe provided the foundation for many of the subsequent reforms to the SISA, reflecting a governmental policy response to the increasing rates of participation and accumulation of retirement savings through superannuation.

Yet the characteristics of the ESF meant that these types of fund were historically not a priority for prudential regulation. The 1997 Wallis Report opined that it was inappropriate to prudentially regulate these types of superannuation fund and the Government subsequently acted to move their administration to the ATO. The closeness of the relationship between SMSF members and fund assets was soon recognised with amendments to allow the investment of up to 100% of an SMSF's assets in business premises that were leased to a member or the employer-sponsor of the fund. While trustee licensing and strengthening of the trustee covenants were important reforms to the SISA aimed at making superannuation stronger for APRA-regulated superannuation funds, the SMSF had different attributes that meant these had no or limited application.

As a result of historical developments and on-going reforms, the SISA regime has become complex. It contains the provisions for the prudent management of superannuation entities and restrictions to prevent abuse of the concessional taxation treatments available in the Tax Acts. These matters are critical, given that superannuation is an important tier of governmental retirement income policy and is now compulsory through the introduction of the SG. However, while there is a justified need for the public to be confident that their growing interests in superannuation are safe, the SISA recognises that not all superannuation funds are the same and neither should they all be subject to the same level of prudential regulation. The SMSF exemplifies this position with a differentiated approach through exceptions and modifications in the SISA to the rules that otherwise apply to APRA-regulated superannuation funds.

2.5 Synthesis

This chapter has identified the broad context underpinning the existence of superannuation in Australia. It first addressed the meaning of superannuation and then elusive nature of a superannuation fund having the necessary attributes to satisfy the statutory conditions for a concessional taxation treatment. An historical analysis was appropriate for both of these matters to demonstrate their fluidity over time. The term “superannuation” has evolved beyond traditional applications in employment relationships and no longer discriminates against those that are self-employed in society. The phrase “superannuation fund” has been statutorily developed, initially in early taxation law and later in prudential regulation. It is ultimately a sub-species, the complying superannuation fund, which combines elements from both areas of law to produce the necessary features to enjoy the holy grail of concessional taxation.

To appreciate the current position and importance of superannuation for retirement income savings, this chapter also considered its slow evolution from a tool used by a narrow and privileged section of the community to achieving broad participation. Government was initially unconvinced as to the suitability of superannuation for the broader populous, repeatedly investigating alternatives such as a universal compulsory funded scheme. Yet by the 1940s the broadening of the income tax base for individuals meant the tax exemption on superannuation fund earnings presented an attractive opportunity to redirect income. This arbitrage peaked in the 1950s when the top marginal rate of personal income tax reached 75%. Participation in superannuation then grew considerably in the 1980s with award superannuation and through the introduction of compulsory SG in 1992, bringing a larger range of participants. Up to and after this time superannuation continues to be shaped by a multitude of inquiries, which have variously sought to clarify, expand and limit its operation.

Coinciding with increases in participation in superannuation and its acceptance as a central part of governmental retirement income policy, this chapter has revealed corresponding changes to the tax concessional treatment of superannuation. The early position in the ITAA1915 was extremely generous, permitting uncapped deductible contributions, an income tax exemption for superannuation fund investment earnings and limited taxation of lump sum benefits. However, even if Government policy was to maintain this level of support, the subsequent increase in participation would have made it extremely difficult from a fiscal perspective. Unsurprisingly, the level of tax incentives for superannuation were reduced over time until reaching the current position in the ITAA1997 whereby both concessional and non-concessional contributions are capped, fund earnings are taxable and benefit payments taxable depending their quantum, form (pension or lump sum) and age of the recipient. Nonetheless, while the taxation incentives have reduced, putting aside the degree of compulsion through the SGC, they remain the underlying reason for the continued existence of superannuation in Australia, including the SMSF.

Alongside the availability of a concessional taxation treatment are the connected restrictions on the activities that a superannuation fund may undertake. This chapter has revealed that early taxation law had a dual revenue and regulatory function. However, the latter role was eventually addressed through separate prudential regulation and oversight. The current SISA regime has produced a comprehensive, though somewhat complicated, matrix of prudential requirements which a superannuation fund must comply with in order to receive a tax concessional treatment. A one-size-fits-all regulatory approach applies to a number of different superannuation entities, with differentiation achieved through modification and exemptions from certain aspects. The SMSF is one such vehicle that receives special treatment, consistent with the limited case for its prudential management and a compliance based administration under the ATO. This unique positon of the SMSF justifies a focussed analysis, which is the objective of Chapter 3.

PART TWO – CONTEXT UNRAVELLED

CHAPTER THREE: RISE OF THE SMSF

3.1 Introduction

This chapter narrows the broad historical consideration of superannuation in Chapter 2 to examine a particular superannuation vehicle, the self-managed superannuation fund (SMSF). While trust law provides an early basis to identify these types of small superannuation fund, and is subject to further consideration in Chapter 4, the critical importance of tax concessions supporting their existence justifies taxation law as the better starting point. Accordingly, this chapter initially considers the origins of the SMSF through predecessor small superannuation funds in historical taxation legislation. The analysis then expands to consider the emergence of the vehicle through prudential regulation.

The analysis reveals that taxation law has, to varying degrees, accommodated the existence of small superannuation funds for some time. Yet it has also refrained from specifically separating them from the broader categories of superannuation fund to which they have been allocated. This approach commenced in the *Income Tax Assessment Act 1915* (Cth) (ITAA1915), with the categories of eligible employer-sponsored superannuation funds and those subject to the general trust taxation. While further categories were added over time, they did not specifically identify small superannuation funds until the legislative focus turned to prudential objectives.

Continuing to rely on the Commonwealth Government's (Government) taxation power for legal efficacy, the *Occupational Superannuation Standards Act 1987* (Cth) (OSSA) and *Occupational Superannuation Standards Regulations 1987* (Cth) (OSSR) made the first inroad towards identifying small superannuation funds. Specifically, the OSSR differentiated superannuation funds with five members or less for the purposes of appointing an approved auditor.[1] Subsequently, the OSSR adopted the category of excluded superannuation fund (ESF) to mean a superannuation fund of which there are fewer than five members.[2] Consistently, the same definition was included in the *Superannuation Industry (Supervision) Act 1993* (Cth)[3] (SISA). The separation of ESFs enabled a relaxation of the prudential restrictions that applied to other regulated superannuation funds, though the simplistic definitional requirement of fewer than five members proved insufficiently precise. This concern was addressed in 1999 by replacing the ESF category with the SMSF.[4]

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1 OSSR s 4(1) (as enacted).

2 OSSR s 18BB(4) (definition of "ESF"), inserted by *Occupational Superannuation Standards Regulations (Amendment) 323/1993* (Cth).

3 SISA s 10 (definition of "ESF") (as enacted).

4 SISA s 17A (definition of "self managed superannuation fund"), inserted by *Superannuation Legislation Amendment Act (No. 3) 1999* (Cth).

To support the qualitative discussion on the emergence of SMSF this chapter also presents a statistical analysis to demonstrate their growth and significance within the Australian superannuation landscape. While this inclusion maybe surprising for a legal thesis, a numeric approach is considered to be a very effective means of substantiating the importance of the SMSF and providing practical context. Although a range of conclusions are drawn, a number of statistical trends for SMSFs and their predecessor small superannuation funds correspond to changes in the extent of legislative restriction on their activity. This response accords with the understanding that the decision to adopt the SMSF structure is premised on the ability and desire of members to control their own superannuation investments for retirement.[5]

3.2 The history of SMSFs in Australia

3.2.1 Early taxation law

The history of superannuation fund taxation in Australia analysed in Chapter 2 demonstrates a significant period during which, subject to certain qualifying conditions, superannuation fund investment income was exempt from taxation.[6] Taxation law also accommodated those superannuation funds that did not satisfy these exemption conditions with a much less concessional taxation treatment.[7] The category of non-exempt superannuation funds was broad, and included funds that although qualified in principle, undertook action during a particular income year which revoked their exempt status and also those that were non-exempt from the very outset due to their structure or purpose.

A small superannuation fund is defined for the purpose of this thesis as a superannuation fund having membership of fewer than five persons. In the absence of an employer-sponsor, early small superannuation funds would have most likely been allocated to the general category of non-exempt funds. Despite legitimate purposes, including the provision of retirement income for self-employed persons in small business or as a family fund to provide additional superannuation support, their less concessional treatment suggests concerns that they may have been used to create excessive benefits. The scope for non-arm's length transactions or making excessive contributions is reflected in the historic taxation approach revealed in

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5 Australian Taxation Office, *Self-managed super funds* (7 December 2016) <https://www.ato.gov.au/Super/Self-managed-super-funds/>.

6 Refer section 2.4.2 of this thesis for discussion of this approach.

7 Refer section 2.4.2 of this thesis for discussion the different categories and taxation treatment of superannuation funds over time.

Chapter 2 to preference a concessional taxation treatment to traditional superannuation funds established for the benefit of employees, with other superannuation funds not within that legislative category (including small superannuation funds) taxed on a less concessional basis.

Some potential for small superannuation funds to be recognised arose from amendments in 1952 to the *Income Tax and Social Services Contribution Assessment Act 1936-1951* (Cth) (ITSSCA1936-1951), which extended the income tax exemption to superannuation funds established for the benefit of self-employed persons.[8] However, while the threshold level of membership was smaller in comparison to many employer-sponsored superannuation funds, it did not assist those with fewer than five members. The new category under s 23(ja)(i) of the ITSSCA1936-1951 required membership of not less than 20 persons, automatically excluding small superannuation funds with a maximum membership of four persons.[9] The change reflected an acceptance that superannuation tax concessions should not be restricted to the employed, though the 20 person membership threshold suggests a lingering policy concern to proceed cautiously.

Recognition of small superannuation funds was also possible with the insertion of Division 9B of Part III of the *Income Tax and Social Services Contribution Assessment Act 1936-1961* (Cth)[10] (ITSSCA1936-1961) and its later refinement through amendments to the *Income Tax and Social Services Contribution Assessment Act 1936-1964* (Cth)[11] (ITSSCA1936-1964). The changes established an exclusive code for superannuation funds to qualify as exempt from income taxation and the basis on which those that did not qualify would be assessed.[12] However, while the changes were significant, they did not ultimately seek to identify the category of small superannuation funds. There was a continuation of four broad categories: tax exempt superannuation funds for employees, tax exempt superannuation funds for self-employed persons, superannuation funds coming within an intermediate class that enjoyed limited tax relief and those that were not concessionally taxed.[13] Small superannuation funds would continue to be accommodated within these classes without specifically identifying their attributes in a legislative category of their own.

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8 *Income Tax and Social Services Contribution Assessment Act 1936-1951* (Cth) s 23(ja) inserted by *Income Tax and Social Services Contribution Assessment Act (No 3) 1952* (Cth).

9 ITSSCA1936-1951 s 23(ja)(i).

10 ITSSCA1936-1961 Div 9B of Pt III, inserted by *Income Tax and Social Services Contribution Assessment Act 1961* (Cth).

11 ITSSCA1936-1964 Div 9B of Pt III, amended by *Income Tax and Social Services Contribution Assessment Act 1936-1964* (Cth).

12 The only exception to the exclusivity of ITSSCA1936-1964 Pt III Div 9B was in respect to withholding tax arising under ITSSCA1936-1964 Div 11A.

13 Refer ITSSCA1936-1964 ss 23F, 23(ja), 79.

Given their membership size and potential absence of a contributing employer, a small superannuation fund would at best come under the intermediate taxation category.[14] The limited taxation concessions and accompanying integrity measures applicable to these types of superannuation fund continued to reflect the policy concern that they could be used for non-retirement income purposes. This view was reflected by the Treasurer's statement when in introducing the category, explaining that the objective was to accommodate "an intermediate class [of superannuation fund] that often caters for the general public, whether employees or otherwise, and which, while serving a useful role in providing retirement benefits for people not able to participate in the traditional type of fund, is, nevertheless, to some extent, used to accumulate tax-free savings for contributors".[15]

Broadly, these taxation arrangements continued with little scope for the recognition of small superannuation funds until 1984, when s 23FB of the *Income Tax Assessment Act 1936* (ITAA1936) was inserted to address the intermediate tax category.[16] Subject to certain preconditions, the new category of s 23FB funds was exempt from income taxation rather than adopting the earlier less concessional approach. The development was an important step in providing a more consistent taxation treatment across the different categories of superannuation fund. However, despite the significance of the change, the s 23FB fund category was not restricted to small superannuation funds, nor did it attempt to provide them with any separate statutory recognition.

The final stage for the potential taxation law recognition of small superannuation funds was reached in 1987 upon the introduction of the OSSA regime. This led to the transfer of the restrictions in s 23(ja), s 23F, s 23FB and s 121C of the ITAA1936, which were applicable to each taxation category of superannuation fund across to the OSSR.[17] The different categories of superannuation fund were subsumed into one provision that linked to the satisfaction of restrictions prescribed in the new OSSA regime.[18] The new approach made the eligibility of a superannuation fund to receive a concessional taxation treatment dependent on it obtaining

[14] ITAA1936-1964 s 79.
[15] Harold Holt, Treasurer, 'Income Tax and Social Services Contribution Assessment Bill (No.3) 1964' (Second Reading Speech delivered at the House of Representatives, Canberra, 22 October 1964) 2217.
[16] ITAA1936 s 23FB, inserted by *Income Tax Assessment Amendment Act (No 3) 1984* (Cth); ITAA1936 s 79, repealed by *Income Tax Assessment Amendment Act (No 3) 1984* (Cth).
[17] These requirements were removed from the ITAA1936 by *Taxation Laws Amendment Act (No. 4) 1987* (Cth).
[18] ITAA1936 s 23FC.

notice that it had complied with the OSSA and OSSR.[19] The critical matter for taxation law was not the categories of superannuation fund, but whether or not they had obtained the notice of compliance, leaving it up to prudential regulations to provide any scope to separately identify small superannuation funds.

3.2.2 Excluded superannuation funds under the OSSA

Upon enactment in 1987, the OSSA regime afforded some very limited recognition to small superannuation funds. This was in relation to the appointment of an approved auditor, being a person who would audit and certify the accounts of a superannuation fund. In particular, for a superannuation fund that had five members or less, where the members agreed not to require a registered auditor, then subject to certain conditions they could appoint a person who was a member of the Institute of Chartered Accountants, the Australian Society of Accountants or the Institute of Affiliate Accountants.[20] This concession provided some flexibility when arranging for the accounts and records of the superannuation fund to be audited.

It was not until 1993 that the characteristics of a small superannuation fund were defined in the OSSR under the category of an ESF. However, while the OSSR may have been the first to include the ESF definition, the purpose was more consequential of the enactment of the SISA than any independent initiative. In particular, the initial draft of the SISA contained an anti-avoidance restriction preventing all regulated superannuation funds from intentionally acquiring assets from members or a relative of a member of the fund.[21] The same restriction was to be mirrored in the OSSR to ensure that the same requirement would apply until the commencement date of the SISA.[22] The blanket prohibition intended for the SISA did not, however, pass the Senate without further amendment to exclude the acquisition of listed securities and to create an exception for the acquisition of business real property (BRP) by an ESF from a member or relative of such a member.[23]

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19 OSSA ss 12, 13 OSSA (as enacted). OSSA ss 5(2)(d), 5(2)(e) (as enacted) contained transitional arrangements that the restrictions in ITAA1936 ss 23F, 23FB, 23(ja) would to continue to comply until equivalent requirements were prescribed in the OSSR.

20 OSSR s 4(1) (as enacted).

21 Refer Explanatory Memorandum, Superannuation Industry (Supervision) Bill 1993 (Cth) 19; Supplementary Explanatory Memorandum, Superannuation Industry (Supervision) Bill 1993 (Cth) 5. Both explanatory memoranda refer to Industry (Supervision) Bill 1993 (Cth) cl 62 in discussion of the prohibition, though the restriction was not identifiable at that clause, suggesting that it was included after the Bill was introduced.

22 OSSR reg18BB, inserted by *Occupational Superannuation Standards Regulations (Amendment) 189/1993* (Cth).

23 SISA s 66 (as enacted).

The BRP exception was restricted to acquisitions by an ESF that did not bring the total of such property acquired by the superannuation fund since Royal Assent of the SISA to more than 40% of the total value of assets in the fund.[24] As the SISA broadly applied from 1 December 1993, the described limitation on the acquisition of BRP (and listed securities) was made effective from Royal Assent on 30 November 1993 by further amendment to the OSSR.[25] Accordingly, the OSSR became subject to the same exception for the acquisition of listed securities, and in the case of an ESF, BRP acquired at market value from a member or relative.[26] The OSSR exception only applied where the BRP, together with any other BRP previously acquired from a member or a relative of a member since 30 November 1993 did not exceed 40% (the "acceptable percentage" for an ESF) of the total value of the assets of the fund.[27]

3.2.3 Excluded superannuation funds under the SISA

Other than for the identified transitional purposes under OSSA, the definition of an ESF as a superannuation fund of which there are fewer than five members had principal application under the SISA (and the accompanying SISR).[28] Its purpose was to enable a differentiated application of the prudential restrictions under the SISA. To clarify the nature of an ESF and explain why they should receive special treatment, the Insurance and Superannuation Commission (ISC) released *Superannuation Circular No III.E.1 – Excluded Superannuation Funds* in December 1994 (SC III.E.I). It explained that a less onerous approach to prudential regulation of ESFs was justified as typically members of such funds had a close association with the operation of the fund.[29] This view was consistent with the observation that members were often trustees, family members or close associates and this connectedness enabled them to have direct input into, and responsibility for, the operation of the fund.[30] In contrast to these features, much of the SISA was directed at improving prudential management of superannuation funds where trustees and members did not share such a close personal relationship.

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24 SISA s 66(2)(c) (as enacted).
25 *Occupational Superannuation Standards Regulations (Amendment) 323/1993* (Cth).
26 OSSR reg 18BB(2A), inserted by *Occupational Superannuation Standards Regulations (Amendment) 323/1993* (Cth).
27 OSSR reg 18BB(4), inserted by *Occupational Superannuation Standards Regulations (Amendment) 323/1993* (Cth).
28 SISA s 10 (as enacted); OSSR reg 2.01 (as enacted).
29 Insurance and Superannuation Commission, Superannuation Circular No III.E.1: Excluded Superannuation Funds (1994) [6].
30 Insurance and Superannuation Commission, Superannuation Circular No III.E.1: Excluded Superannuation Funds (1994) [7].

SC III.E.I also stated that the purpose of applying the SISA restrictions to an ESF was to ensure that the taxation concessions to which they were entitled were genuinely used for retirement income purposes, rather than focussing on prudential objectives.[31] Consistently, the ESF definition was applied in the SISA and SISR to limit the prudential requirements that would otherwise apply to a regulated superannuation fund. The extent of modification for the ESF was significant and included exceptions in relation to the following requirements:

- A trustee should not be subject to direction from others.[32]
- The exercise of trustee discretion by persons other than the trustee.[33]
- Amendment of governing rules of a superannuation entity.[34]
- Acquisitions of certain assets from members of regulated superannuation funds prohibited.[35]
- Equal representation of employers and members of employer sponsored funds.[36]
- The duty to establish arrangements for dealing with inquiries and complaints.[37]
- Duty of trustee of employer-sponsored fund to establish procedure for appointing member representatives.[38]
- The duty of trustee of employer-sponsored fund to establish procedure for appointing independent trustee or independent member of board of directors of corporate trustee.[39]
- Amounts may be paid out of an employer-sponsored fund to an employer-sponsor.[40]
- Capital adequacy requirements for persons appointed as custodians of superannuation entities.[41]
- Individuals not to be investment managers of superannuation entities.[42]
- Disqualified persons not to be investment managers of superannuation entities.[43]
- Financial assistance for superannuation entities that have suffered loss as a result of fraudulent conduct or theft.[44]

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31 Insurance and Superannuation Commission, Superannuation Circular No III.E.1: Excluded Superannuation Funds (1994) [8].
32 SISA s 58 (as enacted).
33 SISA s 59 (as enacted).
34 SISA s 60 (as enacted).
35 SISA s 66 (as enacted).
36 SISA Part 9 (as enacted).
37 SISA s 101 (as enacted).
38 SISA s 107 (as enacted).
39 SISA s 108 (as enacted).
40 SISA s 117 (as enacted).
41 SISA s 123 (as enacted).
42 SISA s 125 (as enacted).
43 SISA s 126 (as enacted).
44 SISA Part 23 (as enacted).

- The requirement to formulate and give effect to an investment strategy.[45]
- Information and reporting requirements to members and others.[46]
- Requirements concerning the audit of fund accounts and lodgement of annual returns.[47]

While the justification for these modified prudential constraints was based on the typically close association of ESF members, SC III.E.I did not attempt to relate this explanation to the words used in the ESF definition. This appears to be due to the fact that the definition could not be construed to require a close association by members in the operation of the fund. Nor did the definition attempt to specify the types of relationships that were identified as being consistent with such an association. Accordingly, it seems that the true reason for reduced prudential regulation of the ESF rested with a perceived understanding of the type of member participation rather than definitional prescription. This conclusion is supported by the notable absence of any detailed statistics on ESF participation until 1997, when the ISC provided Government with the results of a limited survey on 1,000 ESFs and follow-up field work.[48]

3.2.4 SMSFs under the SISA

Although the ESF definition in the SISA was replaced, there was significant deliberation prior to that change.[49] As a starting point, the Government established the Financial System Inquiry[50] (FSI) in 1996 to re-examine the financial system, having last been the subject of a Committee of Inquiry in 1981.[51] The resulting 1997 Financial System Inquiry Final Report (Wallis Report) addressed the circumstances of ESFs and made the following recommendation:[52]

> The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable.

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45 SISR reg 4.09 (as enacted).
46 Refer to exceptions contained in SISR Part 2 (as enacted).
47 SISR regs 1.04(2), 8.03, 11.02 (as enacted).
48 Refer Explanatory Memorandum, Superannuation Legislation Amendment Bill (No 4) 1999 (Cth) 5.
49 SISA s 10 (definition of "excluded superannuation fund") was repealed by *Superannuation Legislation Amendment Act (No 3) 1999* (Cth).
50 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry* (1996).
51 Committee of Inquiry, Commonwealth Government of Australia, *Australian Financial System* (1981).
52 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 334.

> Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries - in relation to financial safety, there should be no regulatory assurance attaching to such schemes.
>
> ….
>
> At present, some excluded superannuation funds have beneficiaries who are at arm's length from the trustees. This is unsatisfactory to the extent that there is little protection of the interests of these third-party beneficiaries and because there is little practical scope for effective prudential regulation of such funds. The Inquiry considers that funds which have third-party beneficiaries should not be regarded as excluded funds. On balance, the Committee would prefer to discourage this particular configuration of the superannuation structure.

The formal expression of these views pushed the discussion of ESFs into the public domain and likely raised further questions as to the role and legitimacy of these vehicles in the context of Government's retirement income policy. The key concern surrounding the inappropriateness of prudential regulation reflected the difficulty with the SISA one-size-fits-all approach, even with modifications made to limit the more unsuitable restrictions. This view appears to be predicated on there being a close association between trustees and members of the ESF in the operation of the fund as being the correct type of relationship for these types of superannuation fund. While the ESF definition did not require such attributes, the Wallis Report considered that arm's length beneficiaries were unsatisfactory due to the difficulties in protecting their interests and that such configurations should not be accepted.

Adding further concern surrounding the role and activities of the ESF, a 1997 ISC survey provided to the Government on 1,000 ESFs and follow-up field work revealed various integrity issues.[53] Although the survey was criticised for using a small sample,[54] it identified the following practices that needed redress:[55]

- Superannuation savings were being transferred into related trusts that were not subject to the investment rules or other SIS regulation, and that were controlled by an employer-sponsor or member. It was considered complex and resource intensive for the regulators to apply the investment rules to superannuation funds on the basis of activities undertaken by an increasing number of unregulated, related entities.

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[53] Refer Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 5.

[54] Senate Select Committee on Superannuation and Financial Services, Parliament of the Commonwealth of Australia, *Report on the Superannuation Legislation Amendment Bill (No 4) 1999* (1999) 41.

[55] Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 5.

- Assets were being leased to an employer-sponsor or member, either through a unit trust or directly by a superannuation fund. This resulted in the fund's assets being committed to the employer's business or being accessed for current day use by members.
- Where a superannuation fund invested in a related trust, the employer or member was able to use the assets in a geared investment, which the superannuation fund could not undertake directly. This circumvented the rule that prescribed borrowing by a superannuation fund.

Alternative options

The recommendation of the Wallis Report had a significant influence on refining the ESF definition by addressing the substance of the relationship. Subsequent discussion of the regulatory position on ESFs came from Treasury's Economics Legislation Committee (ELC) during consideration of the policy intent behind their reduced prudential control under the SISA. The ELC noted that the existence of arm's length membership in about 10% to 15% of ESFs did not necessarily reflect the type of very close relationship whereby members could access information and exert influence over the fund's operations.[56] The ELC considered that the existence of arm's length members warranted reconsideration of the ESF definition to ensure that it achieved the coverage that was envisaged when SISA was introduced.[57] The reluctance to elaborate on this intended coverage suggested that some uncertainty existed as to what was in fact originally envisaged. The simplistic ESF definition was insufficiently precise to restrict the types of structures that could qualify or indicate what was intended.

One way to address the predicament was to redefine the characteristics of an ESF, restricting the types of small superannuation fund that could have limited prudential regulation to those with the correct trustee-member association. Another approach was to simply remove all the

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[56] Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Transcript of Committee proceedings 20/11/1997 subprogram 7.4- superannuation* (1997) <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Festimate%2Fecomd971120a_sec.out%2F0034;page=0;query=Program%207--%20Insurance%20and%20Superannuation%20Commission%2020%2F11%2F1997;rec=0;resCount=Default>.

[57] Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Transcript of Committee proceedings 20/11/1997 subprogram 7.4- superannuation* (1997) <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Festimate%2Fecomd971120a_sec.out%2F0034;page=0;query=Program%207--%20Insurance%20and%20Superannuation%20Commission%2020%2F11%2F1997;rec=0;resCount=Default>.

ESF related SISA modifications.[58] While the second option may have been easier, it would have imposed change on the total population of ESFs, rather than the 10% to 15% that had arm's length members. It would also have created a disincentive to ESF growth, effectively returning to the historic approach during much of the time under the OSSA regime with the full range of prudential restrictions applicable to all regulated funds. The departure from this approach was presumably made to the SISA for good reason and any reversion would have been likely to cause other anomalies. For example, an ESF would have needed to establish an internal complaints resolution system to resolve member complaints about the same decisions that members had made in their capacity as trustees.

In 1999 the Government announced that the matter would be resolved by amending the definition of an ESF to identify specific requirements that would ensure all such superannuation funds were in fact self-managed.[59] The announcement reflected the need to ensure that all members of an ESF could protect their own interests and as a result support the application of only minimal prudential regulation.[60] The approach was consistent with the Wallis Report recommendation, although adopting the phrase "minimal prudential regulation" rather than the more extreme suggestion to remove of all prudential regulation.[61] The different terminology presumably reflected the reality that ESFs could not be conducted entirely at the risk of members, particularly given the residual role of the publicly funded old age pension in the event of their failure.

Exposure draft definition

The ESF definition was to be replaced with the term SMSF and, reflecting the significance of the change, it was contained in an Exposure Draft (ED) released for public consultation.[62] The ED definition of a SMSF contained the following requirements:[63]

(A) The fund has fewer than five members; and
(B) All of the members are trustees and there are no other trustees; and
(C) There is a family or business relationship between the members of the fund.

58 Commonwealth of Australia, 'Budget 1998-99, Budget Measures, Budget Paper No.2' (1998) 2-13.
59 Commonwealth of Australia, 'Budget 1998-99, Budget Measures, Budget Paper No.2' (1998) 2-13.
60 Commonwealth of Australia, 'Budget 1998-99, Budget Measures, Budget Paper No.2' (1998) 2-13.
61 Commonwealth of Australia, 'Budget 1998-99, Budget Measures, Budget Paper No.2' (1998) 2-13.
62 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth).
63 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(1).

The first limb of the definition simply continued the limitation on membership size that had applied to the ESF.[64] The Explanatory Memorandum to the ED did not seek to identify the reasons why the limit had been struck at fewer than five members.[65] Possibly it was based on the historic notions of a family unit, being two parents and two children, though that is uncertain. Another reason why the ED may have avoided this issue is the inherent difficulty in justifying any subjectively determined limit, particularly when faced with claims of discrimination against families with larger numbers of children.

The second limb of the definition created a trustee-membership rule, and was aimed at greater and equal member participation in fund decision making. For non-corporate trustee structures, it required that all of the members of the SMSF were trustees and there were no other trustees.[66] A limited exception existed for single member funds that required two individual trustees, one of which was the member and the other a natural person with a prescribed business or family relationship to the member.[67] The exception addressed the operation of trust law, which prevented an individual from being both sole trustee and beneficiary of a trust without ending the trust through merger of legal and equitable interests in trust property. For corporate trustee structures, each director of the body corporate was required to be a member of the SMSF and each member to be a director of the body corporate.[68] An exception applied for single member corporate trustee funds, requiring the member to be either a sole director or one of two linked directors of the body corporate.[69]

The third limb of the definition required that each member of the SMSF was linked to each other member of the fund.[70] For this purpose, an individual (individual A) could be linked to another individual (individual B) through one or more of the following family or business relationships:

- A relative, as further defined.[71]
- Directors of a company that is carrying on a business.
- Trustees of a trust that is carrying on a business.

64 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(1)(a).
65 Explanatory Memorandum, Exposure Draft Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) 8.
66 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(1)(b), (d)(i).
67 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(2)(b).
68 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(1)(c), (d)(ii).
69 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(2)(a).
70 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(1)(e).
71 Exposure Draft, Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) s 17A(7) (definition of “relative”).

- Partners in a partnership that is carrying on a business.[72]

The linkage requirement of a close personal or business association between SMSF members addressed the earlier concern of the Wallis Report that some ESFs had members that were at arm's length to the trustee(s).[73] The presence of that characteristic was perceived to increase the risk of members not sharing a commonality of interest or equality of influence over fund administration and management. Yet, a potential difficulty with the proposal was that it provided examples of consistency with self-management as initially observed in SC III.E.1 instead of specifying an underlying criterion. The approach was perhaps helpful to encourage self-management, though it did not exhaust the full range of situations that could demonstrate a close association by members with the operation of the fund.

Final definition

The ED definition of a SMSF was subsequently referred to the Senate Economics Legislation Committee (SELC) for detailed consideration and report by 22 June 1999.[74] While the SELC recommended that the proposed definition be enacted into law, the consultation process had revealed extensive levels of public dissatisfaction with the changes. This was not surprising given the limited requirements of the former ESF definition and lack of any comprehensive empirical analysis on membership configurations.

Ultimately, the final composition of the SMSF definition was introduced by *Taxation Laws Amendment Act (No.3) 1999* (Cth). Although the first two limbs of the ED definition were adopted, the third limb was not accepted in its proposed form. In addition, a fourth limb was added which had not been considered by the SELC. The discussion below considers the issues affecting this outcome.

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72 Explanatory Memorandum, Exposure Draft Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) 9.

73 Based on APRA's annual return data approximately 16% of ESFs at the time contained arm's length members. Refer Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 162.

74 Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 159.

(A) The fund has fewer than five members

Although accepted by the Government without modification, the first limb of the ED definition requiring membership of an SMSF to be fewer than five persons came under immediate scrutiny during the consultation process. This appears to have been largely due to frustration with the desire to simply continue, rather than re-examine, the quantitative membership restriction contained in the former ESF definition. In support of the four member limit, the Government informed the SELC that the proposed number of less than five was "about right" for this type of fund and that few people had raised the issue during the operation of the former ESF definition.[75] While the phrase "about right" was not particularly convincing, the subsequent statistical analysis in this chapter[76] demonstrates that the most common number of members for an SMSF is in fact one or two.

Apart from disappointing families or linked business associates of five or more persons, the reluctance to engage in a more thorough debate reflects the previously identified subjectivity in choosing any quantitative limit. That said, there was some merit in the Government's position that increased membership could diminish the ability of all members to participate in management of the fund, which was the essential characteristic identified in the Wallis Report to support removal of prudential restrictions. It was also perhaps convenient that maintaining the limit of fewer than five members would not provide any additional encouragement for these vehicles, given the historical caution to extending a concessional tax treatment to small superannuation funds.

(B) All of the members are trustees and there are no other trustees

The second limb of the ED definition – requiring that each member be a trustee or director of the trustee company of the SMSF – drew less criticism than the other restrictions. The necessity for all members to be trustees was intended to ensure that each member was fully involved and had the opportunity to participate equally in the decision making processes of the fund (i.e. truly self-managed).[77] The fact that most submissions to the ED had supported the second limb was a positive reflection on the ESF market, as the willingness of members to take on the responsibilities of a trustee demonstrated their commitment to self-management

75 Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 172.

76 Refer section 3.3.2 of this thesis.

77 Explanatory Memorandum, Exposure Draft Superannuation Legislation Amendment Bill (No 3) 1999 (Cth) 8.

and distinguished them from other types of superannuation funds. For those members who did not wish to participate in the management of their ESF, it was difficult to argue why they would not be more suited to a professionally managed and prudentially regulated superannuation fund.

A dissenting position on the trustee-membership requirement raised an option of allowing a member of a SMSF to elect not to be a trustee.[78] This approach was largely advanced on the basis that all superannuation funds, whether large or small, are based on a trust structure.[79] Accordingly, by making all members a trustee of the SMSF, they would necessarily become subject to trust law duties and responsibilities, which they may not necessarily wish to assume. An election would have also made an easier transition from the ESF definition, which did not contain a trustee-membership requirement. However, an election of this type was not accepted as being consistent with the attributes necessary to justify reduced prudential supervision. Where SMSF members were unwilling to accept their responsibilities then that may indicate a likelihood of reduced participation in decision-making. Other than persons disqualified from being a trustee, it was unlikely that the second limb would have caused significant disruption.

(C) There is a family or business relationship between the members of the fund

The third limb of the ED definition addressed the concern raised in the Wallis Report that arm's length members may be unable to adequately participate in fund decision making. However, while this objective may have been assisted in some cases by imposing a link requirement, further investigation revealed that the proposal could yield a number of presumably unintended outcomes. One such consequence was that an ESF whose members were connected by friendship rather than family or business relation would not qualify as a SMSF. An ESF whose membership comprised a same sex couple would also have an insufficient connection to qualify as an SMSF, with those individuals not satisfying the definition of a relative. Other issues with the link requirement would evolve over time, such as when business relationships between otherwise arm's length parties were dissolved, rendering the superannuation fund ineligible to remain as a SMSF.

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[78] Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 170.

[79] Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 170.

To compound the deficiencies of the link requirement the Government was unwilling to provide Capital Gains Tax (CGT) rollover relief to those ESFs that were ineligible to transition to a SMSF. It was stated that an ESF that was ineligible to become an SMSF would not incur a CGT liability where it became a Small APRA Fund (SAF) or paid out the departing member's entitlement from cash reserves.[80] However, it also accepted that in limited circumstances the only assets available to satisfy the member's transfer would be assets subject to CGT. Given the exception for ESFs to apply up to 40% of the value of their assets to acquire BRP from their members and their associates, combined with likelihood of other non-cash assets, the situations where a CGT liability would arise may have been understated.

Consistent with the difficulties of the link requirement it did not withstand legislative scrutiny by the Senate. In describing the changes as some of the weakest presented, the Senate noted that the Government had offered absolutely no evidence in support of the proposal that arm's length ESF members were somehow misrepresented.[81] In this regard, they were correct in recognising that not all arm's length members were by default unable to represent their interests. The observation highlighted the bluntness of the proposed change and the failure to recognise that in many situations SMSF members may be more confident in expressing their views to fellow arm's length members rather than linked relations. This reiterated the difficulty of codifying the principle of self-management through the use of examples that had been observed to be consistent with a sufficiently close member association.

The rejection of the proposed link requirement was a particularly important step in defining the characteristics of an SMSF. It discarded the historical notion that ESF participants should be connected by business or family relationships as a means of ensuring a sufficiently close association by members in the operation of the fund. Although these types of fund construction may have been representative of the more typical scenario, there was little evidence to indicate that arm's length non-business related membership was necessarily inconsistent with participation in superannuation fund decision making. Where this characteristic could be demonstrated, it was difficult to reason why such configurations should not also benefit from limited prudential restriction.

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80 Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 173-174.

81 Stephen Conroy, Shadow Minister for Financial Services and Regulation, 'Superannuation Legislation Amendment Bill (No.3) 1999' (Second Reading Speech at the Senate, Canberra, Monday 20 September 1999).

Ultimately, the Senate sought a middle ground in relation to the association of members by recognising that in certain circumstances some arm's length members of an ESF may not be able to effectively represent their interests. A particular concern was identified where employees were members of an employer-sponsored ESF, and potentially remained even where the employee was a trustee, given the often unequal nature of an employment relationship.[82] On this basis, the third limb was narrowed to prevent an employee of another member from also being a member of an SMSF, unless the members concerned were related.[83] Apart from this restriction, arm's length members were permitted to remain and transition from an ESF to a SMSF.

(D) No remuneration

Although not considered by the SELC or contained in the ED, a further limb was added to the SMSF definition upon enactment. It specified a requirement to ensure that no trustee of the SMSF received any remuneration from the fund or from any person for any duties or services performed by the trustee in relation to the fund.[84] This inclusion was explained as being analogous to the former ESF definition.[85] Yet at the time of repeal the definition of an ESF contained no such requirement. It is suggested that its inclusion was more appropriately justified as a simple reflection of the corresponding general law applying to trustees.[86]

3.2.5 Review of SMSFs under the SISA

In 2009 the Government announced the Super System Review[87] (Cooper Review) which, as canvassed in Chapter 2, was tasked with examining the governance, efficiency, structure and operation of Australia's superannuation system. While the 2010 Super System Review Final Report[88] (Cooper Report) provided a range of recommendations, most relevant to the present analysis it devoted an entire chapter to the operation of the SMSF sector.[89] While a number of

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82 Stephen Conroy, Shadow Minister for Financial Services and Regulation, 'Superannuation Legislation Amendment Bill (No.3) 1999' (Second Reading Speech at the Senate, Canberra, Monday 20 September 1999).
83 SISA s 17A(1)(e) (as enacted).
84 SISA s 17A(1)(f) (as enacted).
85 Explanatory Memorandum, Superannuation Legislation Amendment Bill (No.3) 1999 (Cth) 16.
86 The prohibition was subsequently extended to directors of an SMSF corporate trustee. Refer SISA s 17A(1)(g), inserted by *Tax Law Amendment (Simplified Superannuation) Act 2007* (Cth).
87 Superannuation Review Panel, *Super System Review* (2009).
88 Superannuation Review Panel, *Super System Review Final Report* (2010).
89 Superannuation Review Panel, *Super System Review Final Report* (2010) ch 8.

issues were identified, the broad conclusion was that SMSFs operated successfully and were well-functioning.[90]

The Cooper Review informed its view on the SMSF sector partly through public consultation on a range of issues that it considered worthy of review. The first issue was to revisit the SISA definitional requirement that SMSF membership be limited to fewer than five persons. It also questioned whether a de minimis level of assets under management was appropriate to restrict entry into the SMSF market, and whether third party asset custodians should be engaged as commonly occurs with Australian Prudential Regulation Authority (APRA) regulated funds. A further matter was to consider the appropriateness of the trust as the legal structure prescribed by the SISA definition of an SMSF. Potential for inconsistency with the paternalistic characteristics of the trust relationship arose given the early view that such schemes should be conducted entirely at the risk of the beneficiaries and the ensuing modifications to relax the prudential restrictions under the SISA.

Membership limit

Many submissions to the Cooper Review addressed whether the SMSF definitional requirement of fewer than five members should be increased to improve its ability to include all members of a larger family within the one fund.[91] However, the reasons advanced to support an increase were essentially the same as those that had been made unsuccessfully when the SMSF definition was originally inserted into the SISA. Although the Cooper Report acknowledged that the existing restriction on membership was somewhat arbitrary, it was not persuaded to recommend that the limit be increased.[92]

The general deficiency with the submissions supporting an increase to the SMSF membership limit was that they could not collectively show any particular consensus on the extent of the increase. Even assuming that this difficulty could be overcome, the Cooper Report identified the concern that increased membership would introduce complexity and blur the line between SMSFs and other regulated superannuation funds.[93] It is difficult to conclude what level of increased membership might have produced these consequences, though inevitably at some point an increasing membership would lead to inconsistency with all member-trustees being able to participate in the operation of the SMSF. The ability of trustees to retain control and

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90 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 1.
91 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.
92 Superannuation Review Panel, *Super System Review Final Report, Part One* (2010) 47.
93 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

accept ultimate responsibly for fund decision making was identified as an important feature of the SMSF sector that should be maintained.[94] The case for change was diminished further by the statistical fact that at the time of the Cooper Review over 90% of SMSFs had only one or two members.[95]

Asset size and custody

The next issue addressed by many submissions to the Cooper Review was whether entry to the SMSF sector should be subject to a minimum value of assets under management. Support for this type of restriction had historically existed amongst some industry participants; perhaps influenced by the commercial interests of larger industry or retail superannuation funds facing leakage to the SMSF sector. Typically, the question was postulated whether a SMSF with $200,000 or less in assets could be cost competitive with larger APRA-regulated funds.[96] A number of submissions prioritised transparency as more significant than focusing on a cost-to-asset ratio. Consistently, SMSF trustees would be intimately aware of their costs given that they were typically paid directly by them, whereas the fee and commission structure for larger APRA funds had traditionally been more difficult to gauge.

The concern for smaller-sized SMSFs followed earlier Cooper Review statistical analysis that had revealed that on average they lacked diversification, had higher relative costs and underperformed larger-sized SMSFs.[97] To obtain a more informed understanding on the merit of smaller-sized SMSFs the Cooper Review undertook further statistical analysis.[98] The additional work identified the significant consequences of imposing a minimum asset level, given that 26% of all SMSFs in 2008 had $200,000 or less in assets under management.[99] Within this category over 90% of these SMSFs were in the accumulation phase[100] and typically had a higher average expense ratio in comparison to larger-sized SMSFs.[101] Given the number of SMSFs established with $200,000 or less in assets over the 2000 to 2007 financial years,[102] the statistics suggested that new entrants did not remain permanently in the

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94 This feature of "ultimate responsibility" was the first of the Cooper Report's guiding principles for regulation of SMSFs. Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 219.

95 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

96 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

97 Superannuation Review Panel, *A Statistical Summary of Self-Managed Superannuation Funds* (2009).

98 Refer Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 263-266.

99 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 263.

100 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 265.

101 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 264.

102 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 266.

smaller-sized SMSF classification, with an overwhelming trend to move beyond the threshold over time.

Although there was reason for concern about smaller-sized SMSFs that warranted a minimum asset value restriction, there were also competing reasons to resist such a change. The trend for SMSFs to move outside the smaller category over time was a persuasive reason to retain the status quo, as was the inconsistency of barriers to entry with the broader concept of member choice.[103] In the absence of any strong countervailing policy reason, appropriate advice, disclosure and an increase in comparable data were considered sufficient to ensure that more informed decisions were made in establishing SMSFs for a suitable purpose.[104] The expected result would be a reduced instance of smaller-sized SMSFs and therefore a specific recommendation to impose a statutory minimum asset size was unnecessary.

A further issue surrounding SMSF assets was the potential for compulsory use of third party custodians. This option garnered little support from submissions to the SRR and was expediently dismissed. Such a course would have led to additional running costs and was perceived to add minimal benefit in terms of compliance levels.[105] Furthermore, the use of third party custodians would also diminish trustee control. That outcome would be inconsistent with the guiding principle that SMSF members have effectively assumed sole responsibility for their retirement savings.[106]

Trust structure

As previously identified, an important aspect of the SMSF definition in the SISA is the requirement to adopt the trust structure. The submissions to the Cooper Review broadly supported a continuation of the existing trust structure, rather than adopt other alternatives such as a statutorily formed trust or a purely contractual form.[107] These views were more typically influenced by the historical and fiduciary position of a trustee,[108] and also the cost

[103] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 223.
[104] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 223.
[105] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 224.
[106] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 219.
[107] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.
[108] For example: Law Council of Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 19 February 2010, 13; Institute of Chartered Accountants in Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 26 February 2010, [8.1]; Superannuation Professionals Association of Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 26 February 2010, 12; CPA Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 19 February 2010, 8.

and challenges of replacing the trust.[109] These considerations diverted the question from examining the substance of the arrangement and whether the member-trustee relationship was suited to promoting full involvement and the opportunity to participate equally in the decision making processes of the SMSF.

Consistent with the majority of submissions, the Cooper Report highlighted the importance of trusteeship, in that subject to general trust law and legislative intervention, trustees could retain control over all aspects of the SMSF.[110] It also emphasised the importance for the SMSF model of control and the accompanying acceptance by the trustees of ultimate responsibility for fund decision making. These features were identified as characterising the SMSF sector and had contributed to its sustained growth.[111] On this basis, and taking into account the general lack of support by submissions, the Cooper Report did not support the adoption of an alternative structure.

Building on the recommendation to retain the trust structure, a related issue of concern was that, despite the SISA definition of a SMSF permitting the use of a corporate trustee, the overwhelming trend had been to adopt natural person (member) trustees.[112] It was hypothesised that the non-corporate trustee approach may be preferred due to limited advice or underappreciation of the benefits from using a corporate trustee, such as perpetual succession and reduced risk of intermingling SMSF and personal assets. Financial considerations were also identified as being potentially influential, with higher establishment and ongoing registration costs for a corporate trustee. Consistent with the guiding principle of freedom from intervention,[113] there was no recommendation for definitional change to address this issue. The Cooper Review resolved that the matter would be better addressed through separate recommendations on the need for better advice.[114]

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[109] For example: Heffron Consulting Pty Ltd and Cavendish Superannuation Pty Ltd, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 26 February 2010, 3.

[110] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

[111] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

[112] As at 30 June 2009, around 29% of all SMSFs had a corporate trustee and this was trending downward, given that nearly 90% of new SMSFs were established without a corporate trustee in the 2008 and 2009 financial years.

[113] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 219.

[114] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 224.

3.3 SMSF statistics

Having analysed the historical underpinnings of the SMSF and also the more recent inquiry by the Cooper Review into their role and configuration, further contextual insight can be obtained from a complementary statistical analysis. This approach is consistent with the method adopted by the SRR in their consideration of SMSF regulatory matters, with statistical information quantifying the materiality and persuasiveness of submissions on the issues under review. The analysis below reveals the growth in the number of SMSFs (and their predecessor ESFs) over time, along with changes in SMSF membership size, asset values and portfolio investment allocations.

3.3.1 Number of funds

Examining the number SMSFs and their predecessor reveals that, with limited exception, the sector has enjoyed continuing growth. Although there are likely to be a range of factors, such as demographic and economic circumstances, changes in their rate of growth appear to correlate with changes in legislative restriction on their activities. The growth of these vehicles is captured below.

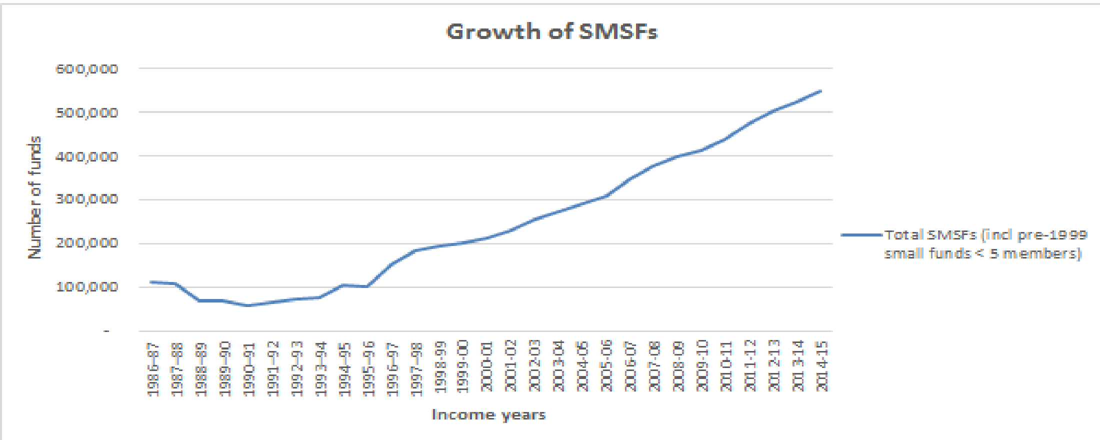

Figure 1: SMSF growth[115]

The following time periods have been identified from Figure 1 to examine the potential influence of legislative intervention on the number of SMSFs and predecessor small superannuation funds:

[115] Figure 1 is based on published and unpublished data collated by APRA and the Australian Taxation Office.

1. Prior to the OSSA regime;
2. Reign of the OSSA;
3. Reign of the SISA.

Prior to the OSSA regime

In the absence of reliable statistical data for the period immediately prior to the introduction of the OSSA regime, it is difficult to draw firm conclusions on small superannuation fund growth for that time. However, given the lead up to the OSSA and likely concerns surrounding its increased focus on prudentially restricting superannuation fund activity, it reasonable so suggest that the proposed changes had a negative influence on fund growth. That would also be consistent with the trend decline after the introduction of the OSSA regime.

As a further negative influence on growth, prior to the introduction of the OSSA regime the taxation law investment restrictions were amended in 1986 to remove the income tax exemption for investment income where a superannuation fund did not comply with the in-house asset rule. This required the superannuation fund to ensure that at all times during the year of income the cost of its in-house assets did not exceed 10% of the cost of all the assets of the fund.[116] Prior to this restriction there may have been an incentive to establish a small superannuation fund due to the ability to combine the purposes of accumulating tax-free savings for contributors with investing in or making loans to their employer-sponsor or members.

Reign of the OSSA

More reliable statistics to substantiate the number of small superannuation funds emerged in 1987, identifying just over 100,000 such funds in existence. This point in time coincided with the introduction of the OSSA, and saw the number of small superannuation funds decline through to 30 June 1991. It is likely that the OSSA regime brought home a reality for many participants that all regulated superannuation funds would be subject to a comprehensive range of prudential restriction, adopting and extending many of the earlier taxation law constraints. The increase in compliance costs for small superannuation funds to satisfy these requirements may have made it uneconomic for many to remain operational. In addition,

[116] ITAA1936 s 121C(4), inserted by *Taxation Laws Amendment Act (No.2) 1985* (Cth).

those small superannuation funds that were used to earn higher returns from commercial or ancillary activities may have preferred to exit the sector so as to avoid scrutiny.

During the period from 30 June1991 to 30 June 1994 the decline in small superannuation funds reversed and their number slowly began to increase. This change may have reflected a growing confidence and familiarity in the OSSA regime by those interested in using superannuation for genuine retirement income purposes. Although the ESF definition appeared in the OSSR in 1993, the limited time for which it had relevance was consistent with having a minimal influence on ESF growth. Towards the end of the OSSA's reign Government statements on the proposed new prudential arrangements for superannuation would have introduced some uncertainty and likely subdued enthusiasm to establish new funds. By 30 June 1994 the number of ESFs had fallen to 75,500.

Reign of the SISA

The growth in ESFs increased rapidly by 38% from 30 June 1994 to reach 104,000 by 30 June 1995. While slightly delayed with some time for the changes to be digested, the increase in ESFs coincides with the introduction of the SISA regime. The exceptions contained in the SISA to accommodate the peculiarities of the ESF would have provided additional encouragement to support their growth. Yet not all modifications were concessional, with some amendments arising soon after the enactment of SISA aimed at restricting ESF activity. For example, in 1994 the exception for ESF acquisitions of BRP from a member or relative of a member was narrowed to property used in the member's (or relative's) principal business.[117] The change limited the scope for such acquisitions given the perceived the dangers (from a prudential, retirement incomes and taxation revenue perspective).[118]

In the ISC's view, some of the ESF growth coinciding with the introduction of the SISA may have been explicable by small corporate superannuation funds changing to ESFs.[119] That would be consistent with participants taking advantage of the less restrictive ESF-related prudential requirements. ISC also suggested that a significant factor could have been high net

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[117] SISA s 66(5) (definition of "exempt business real property"), inserted by *Superannuation Industry (Supervision) Legislation Amendment Act 1994* (Cth).

[118] John Faulkner, Minister for the Environment, Sport and Territories, 'Superannuation Industry (Supervision) Legislation Amendment Bill 1994' (Second Reading Speech at the Senate, Canberra, Thursday 5 May 1994). Robert Elliot, Parliamentary Secretary to the Treasurer, 'Superannuation Industry (Supervision) Legislation Amendment Bill 1994' (Second Reading Speech at the House of Representatives, Canberra, Thursday 20 October 1994).

[119] Australian Prudential Regulation Authority, 'Restructuring the superannuation industry' [1996] (June) *Insurance and Superannuation Bulletin* 12. The further statistics identified in this paragraph and the following paragraph have been sourced from the same article.

worth individuals opting out of their existing employer-sponsored funds and directing contributions into their ESF. This explanation was supported by comparing the growth in ESFs and very small business (i.e. business with less than five employees), given that ESFs grew by 38% in the 1995 income year, while the number of very small business declined by 0.2% during same period. ISC also noted that as at 30 June 1995 there were around 750,000 very small businesses in comparison to only 104,000 ESFs, suggesting that very small business was not a predominant driver of their growth.

The views of ISC on the influence of very small business on ESF growth was not entirely satisfactory without some regard to the possible role of larger sized small businesses. Yet widening the scope of small business does not adequately explain ESF growth given that superannuation coverage of small business operators was trending downwards at that time. The existence of generous CGT concessions for small business operators on disposal of their business provided another reason to suggest small business was more inclined to invest in their own operations rather than save through superannuation.[120] Given these considerations it appears that the spike in ESF growth reflected a combination of factors, particularly the relaxation of prudential restrictions under the SISA, switching between the different types of small superannuation fund and high wealth individuals entering the ESF market from larger funds.

Despite legislative reforms that tended to restrict ESF activity, their number continued to steadily increase and reached 193,396 by 30 June 1999. However, the rate of growth slowed to 3.6% in the 2000 income year, following the replacement of the ESF with the new SMSF category. The change, commencing in October 1999, brought further eligibility conditions that such vehicles would need to satisfy. The requirement that each member be a trustee of the fund or director of the trustee company was a significant structural change that may have contributed to a slowing of SMSF growth. The change would have excluded those existing and new entrants that were unwilling or unable to accept the additional responsibilities of trusteeship. Ultimately, the precise extent to which those circumstanced prevailed remains difficult to gauge.

Coinciding with the SMSF definition, a further influence on fund growth was the change in regulator, from APRA to the Australian Taxation Office (ATO).[121] This would have generated

[120] Refer ITAA1936 s 160ZZR which provided exemption of part of a capital gain attributable to goodwill for small business taxpayers.

[121] Changes to the SISA to accommodate this transfer were made by the *Superannuation Legislation Amendment Act (No. 3) 1999* (Cth).

uncertainty over how the ATO would approach its role, being markedly different to other areas of its tax administration and superannuation responsibilities at the time.[122] A particular concern may have been the inherent conflict of interest, whether actual or perceived that the ATO would focus on revenue collection rather than promoting self-regulation.[123] Uncertainty also existed around whether and the extent to which the ATO was to have any prudential type role.[124] However, what was clear is that the ATO was well equipped to scrutinise SMSF activities in comparison to the approach of the ISC and APRA, which had permitted complacency due to a lack of systems and resources.[125] The historically "light" approach had been identified in the 1997 ISC survey to Government suggesting that ESFs had been allocated to the too-hard basket.[126]

A further negative influence on SMSF growth in 1999 was the amendment of the SISA to include more restrictive in-house asset rules,[127] responding to earlier ESF related party investment concerns identified by the ISC.[128] The changes extended the type of counterparty relationship from a "standard employer-sponsor, or an associate of a standard employer-sponsor, of the fund" to the more broadly defined term, "related party".[129] Accordingly, the in-house asset restrictions encompassed an asset of the fund that was a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party of the fund.[130] The prohibition on the acquisition of assets by the trustee of a

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122 Australian National Audit Office, 'The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds' (Audit Report No 52, 2007) 47.

123 Senate Economics Legislative Committee, Parliament of the Commonwealth of Australia, *Consideration of legislation referred to the Committee, Superannuation Legislation Amendment Bill (No.3) 1999* (1999) 165.

124 Compare: Joe Hockey, Minister for Financial Services and Regulation, 'Superannuation Legislation Amendment Bill (No.3) 1999' (Second Reading Speech at the House of Representatives, Canberra, Wednesday 31 March 1999); Explanatory Memorandum, Superannuation Legislation Amendment Bill (No.3) 1999 (Cth) 1. The second reading speech referred to the ATO being responsible for ensuring SMSFs complied with the "non-prudential requirements" of the superannuation law, while the explanatory memorandum states that SMSFs will be subject to a "less onerous prudential regime". For further discussion, refer Australian National Audit Office, 'The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds' (Audit Report No 52, 2007) 49-50.

125 Evidence to Senate Select Committee on Superannuation, Superannuation Legislation Amendment Bill (No. 4) 1999, Parliament of the Commonwealth of Australia, Melbourne, 18 November 1999, 24 (Mr Wyatt).

126 The ISC survey was not made public, although the findings were outlined at Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 5.

127 Refer *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

128 These concerns are set in Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 5.

129 SISA s 10(1) (definition of "related party"), inserted by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth); SISA s 71, amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

130 SISA s 71(1), amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

superannuation fund from a “fund member or a relative of a fund member” was similarly broadened to prevent acquisitions from a “related party” of the fund, as defined.[131]

However, the effect of an expanded related party definition on SMSF growth was tempered due to an exception that enabled a trustee of a SMSF to enter a lease or lease arrangement over real property with a related party of the fund, provided that the property comprised BRP.[132] A SMSF was permitted to use up to 100% of the value of its assets to acquire BRP from a related party, which was a substantial increase from the earlier 40% acceptable percentage.[133] Rather than restrict growth, these changes would have encouraged small business owners to establish a SMSF so that their superannuation savings could be invested in business premises.[134] The change recognised the limited investment risk surrounding BRP, given that land and buildings generally have an underlying value independent of any related business conducted in them.[135]

Following these reforms, SMSF growth was typically 6-7% per year through to 30 June 2006 and reached 309,088 funds. The rate of growth then accelerated to 13% during to 2007 income year and reached 350,142 by 30 June 2007. This increase corresponds with the release of the Government’s Simpler Super[136] (Simpler Super) reforms aimed at streamlining the superannuation system. While some changes were SMSF specific, such as administrative matters and the supervisory levy,[137] those affecting all regulated superannuation appear to be more influential on SMSF growth. One significant change was the transitional rule accompanying the introduction of concessional and non-concessional superannuation contribution caps. The transitional non-concessional cap was particularly generous, permitting contributions of up to $1 million to be made to a regulated superannuation fund between 10 May 2006 and 30 June 2007. This measure provided a further incentive to establish and direct additional contributions to a SMSF before 30 June 2007.

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131 SISA s 66(1), (2), amended by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

132 SISA s 71(1)(g), inserted by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

133 SISA s 66(2)(b), repealed and substituted by *Superannuation Legislation Amendment Act (No. 4) 1999* (Cth).

134 Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 7.

135 Explanatory Memorandum, Superannuation Legislation Amendment Bill (No. 4) 1999 (Cth) 7-8.

136 *Tax Laws Amendment (Simplified Superannuation) Act 2007* (Cth)*; Superannuation (Excess Concessional Contributions Tax) Act 2007* (Cth)*; Superannuation (Excess Non-concessional Contributions Tax) Act 2007* (Cth)*; Superannuation (Excess Untaxed Roll-over Amounts Tax) Act 2007* (Cth)*; Superannuation (Departing Australia Superannuation Payments Tax) Act 2007* (Cth); *Superannuation (Self Managed Superannuation Funds) Supervisory Levy Amendment Act 2007* (Cth).

137 Commonwealth of Australia, *A plan to Simplify and Streamline Superannuation - Outcomes of Consultation* (2006) 25.

After the spike in the 2007 income year, SMSF growth returned to a 6-7% range through to 30 June 2013 and reached 502,249 funds. Although there were regulatory reforms during this period, such as the Government's Stronger Super[138] (Stronger Super) changes, these do not appear to have had a significant influence on SMSF growth. Taxation related reforms, such as the introduction of a further contribution tax under Division 293 of the ITAA1997 in 2013, and increased political discussion surrounding ways to limit the accumulation of funds in superannuation, are likely to have contributed to the lower growth of around 4% through to 30 June 2015. At this point the number of SMSFs reached 549,747 and reflects the most recent ATO annual data available.

3.3.2 Membership

One aspect of the SMSF that has drawn a range of views due to its subjectivity is the appropriateness of the membership limit of fewer than five persons. While there was some reluctance by Government to discuss this issue upon formulation of the ESF definition, the matter received further coverage during the consultation process that led to the creation of the SMSF. Working against any increase in the membership threshold at that time was the existence of ISC data indicating that one and two member ESFs comprised 85% of all ESFs for the year ending 30 June 1997.[139] Consistently, Figure 2 reveals a continued high concentration of one and two member configurations during the early stages of the SMSF, reaching 87.2% of funds by 30 June 2000.

The SMSF membership threshold also emerged as an issue for consideration during the Cooper Review. While issues surrounding control and complexity were raised as being important reasons why the threshold should not be extended, ATO statistics captured at Figure 2 show that since 30 June 2008 over 90% of SMSFs had contained only one or two members. That position revealed that demand for SMSFs with larger memberships was not significant. Since that time the percentage of one and two member SMSFs has slowly increased, reaching 92.4% of SMSFs by 30 June 2015. Unfortunately, the ATO does not release complementary data to confirm the relationship between members, such as a spousal or de facto connections, which might explain why two member SMSFs are such a popular configuration.

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138 Australian Government Treasury, *Stronger Super* (2013) <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>.

139 Australian Prudential Regulation Authority, 'Focus on excluded funds' [1998] (June) *Insurance and Superannuation Bulletin* 2.

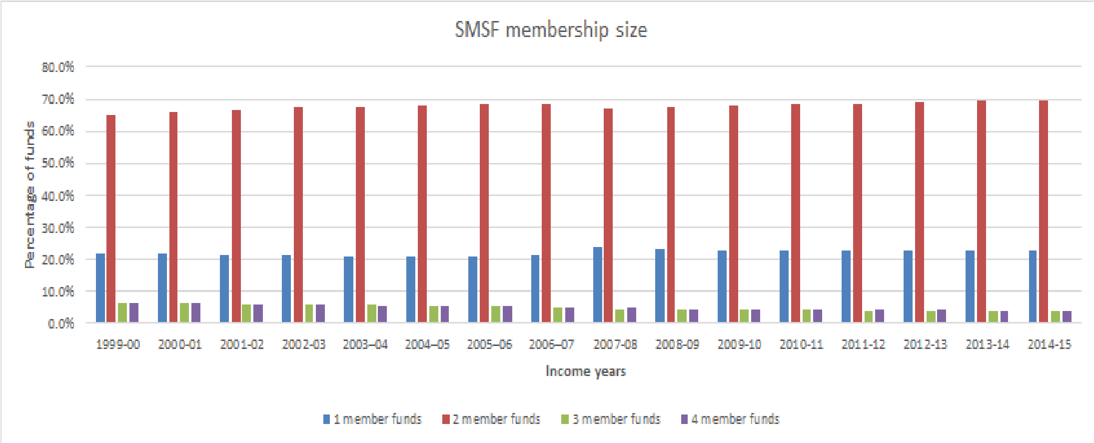

Figure 2: SMSF membership[140]

3.3.3 Average assets per member

Another attribute that historically drew attention to ESFs, and continues to do so for the SMSF, is the average value of member account balances. Commencing with early ISC data, the average assets per ESF account at 30 June 1997 was $130,875.[141] This balance was high relative to other superannuation fund accounts at the time. One explanation for the difference was the tendency for ESFs to be created with a rollover or inward transfer from another superannuation fund instead of commencing with a zero balance. The transfer of mature balances would potentially inflate the ESF average and correspondingly reduce the average for the transferor category. ISC also pointed to anecdotal evidence suggesting that the age profile of ESF membership was also skewed to older ages in comparison to superannuation fund membership generally, which could be expected to result in larger average assets per ESF member account.

Over the following three years there was a 40% increase in the average value of SMSF member assets to $184,094 at 30 June 2000. It is difficult to explain why the average would increase so dramatically over such a short time. The period does correspond with the emergence of the SMSF definition, and so one explanation is that some former ESFs with lower average member balances chose the SAF route rather than transitioning to the SMSF.[142] The change of administrator to the ATO from 1 July 1999, additional compliance costs and

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[140] Figure 2 is based on published and unpublished data collated by ATO.

[141] Australian Prudential Regulation Authority, 'Focus on excluded funds' [1998] (June) *Insurance and Superannuation Bulletin* 2. The next highest average member account balance at 30 June 1997 was $42,918 in public sector funds. The further statistics identified in this paragraph have been sourced from the same article.

[142] Mathew Roberts, 'Self Managed Superannuation Funds – Preliminary statistics' (Paper presented at the Ninth Annual Colloquium of Superannuation Researchers, University of New South Wales, 1 July 2001) 4.

the potential for greater regulatory scrutiny may have also prompted some SMSFs with minimal balances to be wound up.[143] Although investment conditions may have been favourable, it seems improbable that the change could simply reflect market value movements and returns on underlying assets.

Over the next three years Figure 3 shows that the average SMSF assets per member grew at a smaller rate, ranging from 5-8% per year and reached $220,159 at 30 June 2003. The rate of growth then increased to 12%, 18% and 19% for the subsequent three years. At 30 June 2006 the average SMSF assets per member reached $343,859. In the absence of significant regulatory or the taxation changes during this period, it would appear that the high levels of growth reflected prevailing economic conditions for investment.

During the 2007 income year Figure 3 reveals the average value of SMSF assets per member grew very strongly, increasing by 38% to reach $469,343 by 30 June 2007. Consistent with the increase in the number of SMSFs established at this time, it is reasonable to suggest that the growth in SMSF assets per member was influenced by the Government's 2007 Simpler Super reforms. The transitional non-concessional contribution cap of $1 million for contributions made to a regulated superannuation fund between 10 May 2006 and 30 June 2007 provided a narrow opportunity for members to substantially increase their retirement savings. The economic conditions for investment returns also remained positive, contributing to the increase in average member balances.

The continuous growth in the average SMSF assets per member is shown in Figure 3 to have ended during the 2008 income year and continued to fall in 2009, with declines of -4% and -5%. This period follows the introduction of the 2007 *Simpler Super* reforms, which apart from simplification introduced restricted superannuation contributions caps and high rates of taxation for excess concessional and non-concessional contributions. These features reduced the scope to accumulate superannuation savings in comparison to the former age-based contribution limits. The decline in average SMSF assets per member also coincides with the Global Financial Crisis (GFC), which was arguably more influential than any regulatory or taxation reforms. Yet there is also support for the view that due to their conservative investment tendencies SMSFs were on average less affected than other types of

[143] Mathew Roberts, 'Self Managed Superannuation Funds – Preliminary statistics' (Paper presented at the Ninth Annual Colloquium of Superannuation Researchers, University of New South Wales, 1 July 2001) 4.

superannuation fund during this financial downturn.[144] Ultimately, at 30 June 2009 the average asset balance per member had fallen to $426,890.

With the exception of a decline in the 2012 income year, Figure 3 reveals that the average SMSF assets per member has subsequently returned to growth, increasing at a rate of 7-8%. In 2012 the rate of growth fell to -2% and appears consistent with lower investment returns reported by other types of regulated superannuation. At 30 June 2015 the average member asset balance reached $589,636. Although there were legislative reforms, such as those arising from Stronger Super, that fell within this period, it is difficult to draw any particular correlation to the growth in SMSF assets per member. Taxation related reforms, such as the introduction of a further contributions tax under Division 293 of the ITAA1997 in 2013, may have discouraged some members from making additional contributions. However, other changes in 2014 to reduce the severity of taxes on excess concessional and non-concessional contributions may have encouraged others ensure their caps were fully utilised.

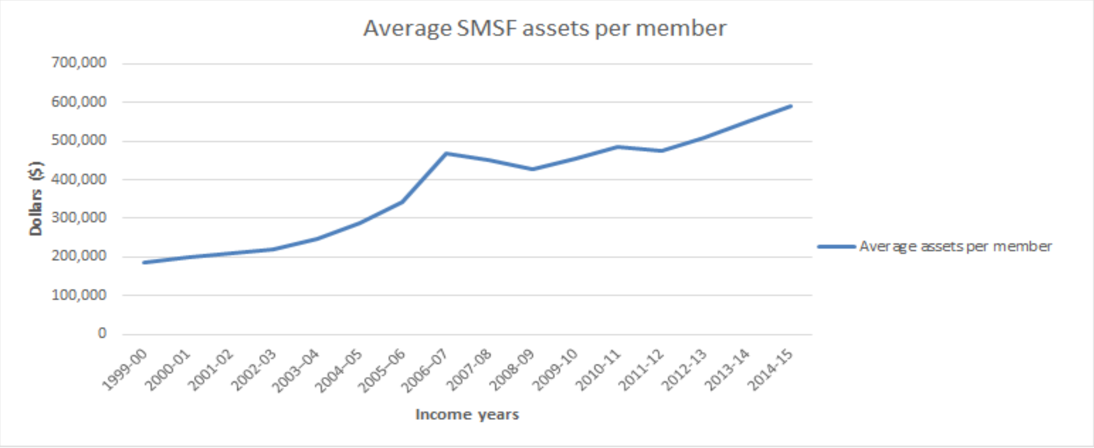

Figure 3: Average assets per member[145]

3.3.4 Asset allocation

When examining SMSF investment portfolio construction, the most immediately recognised feature is that the overwhelming proportion of assets are held directly rather than through the use of managed investments. The attribute is consistent with the objective of self-management and control, rather than outsourcing investment responsibilities to others. However, it is more difficult to make any precise comment on the extent that asset allocations have developed to accommodate tax and regulatory changes. Besides those factors, there are a range of

[144] Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper*.

[145] Figure 3 is based on published and unpublished data collated by ATO.

preferences and individual trustee bias that may influence an SMSF's investment strategy. Accordingly, it is not intended to rationalise why movements in asset weightings have occurred by reference to legislative changes. In any event, the changes in the main asset weightings over time have not been significant.

A further characteristic of the SMSF that has drawn attention is their degree of investment diversification and tendency to prefer particular asset categories. The most heavily allocated direct investment has consistently been in shares and equities, which has overwhelmingly been in Australian listed entities rather than overseas entities. The dominance of this category during the period from 30 June 2000 to 30 June 2015 is shown in Figure 4, comprising between 31-36% of SMSF asset portfolios. The next most significant investment category captured in Figure 4 is cash, securities and term deposits, which represented 22-29% of SMSF asset portfolios during the period 30 June 2000 to 30 June 2015. Together these categories totalled $375 billion at 30 June 2015.

The next largest investment categories are real property and trusts, with each representing 14% of SMSF asset portfolios at 30 June 2015. While Figure 4 shows that the allocation to real property has not significantly changed over time, it also reveals that the level of investment in listed and unlisted trusts tended to decline. Trust investments represented 21-23% of SMSF assets from 30 June 1999 to 30 June 2006, though gradually fell to 12% by 30 June 2012 before making a small recovery by 30 June 2015. Despite recommendations for its removal,[146] limited recourse borrowing may provide additional support for some SMSF real property investment in comparison to trust investments, though such a course can also be used for other asset categories. Together, real property and trust investments totalled $169 billion at 30 June 2015.

The remaining investment categories captured in Figure 4 are managed investments and other, each representing 5% of SMSF asset portfolios at 30 June 2015. The category of other includes the sub-categories of life insurance policies, overseas assets, loans, other property and other. The allocation to managed investments and other has not materially changed since 30 June 2000. Together these categories totalled $58 billion at 30 June 2015.

[146] Commonwealth of Australia, *Financial System Inquiry Final Report* (2014) 86.

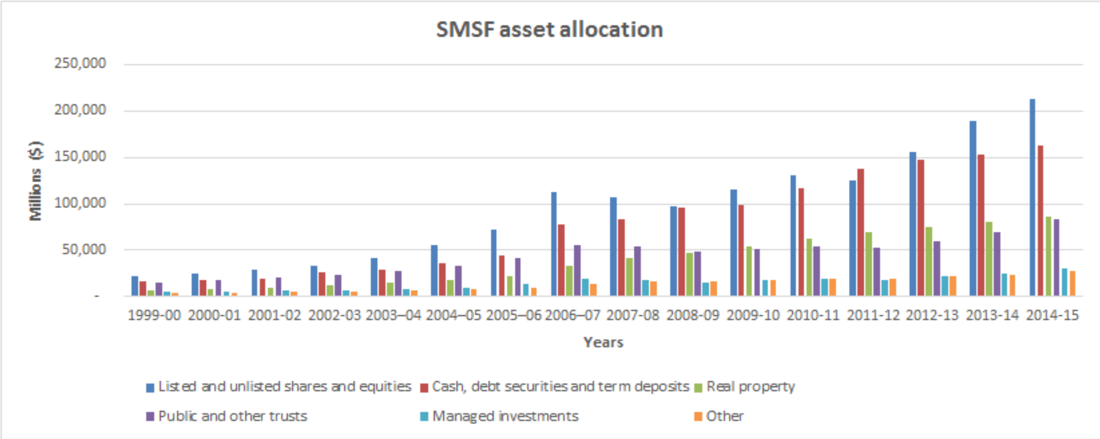

Figure 4: Asset allocation[147]

3.4 Synthesis

This chapter has demonstrated that taxation law has played a critical role in the growth of SMSFs and their predecessor small superannuation funds over time. However, while taxation law historically devised different categories of superannuation fund for the purpose of providing a concessional taxation treatment, it did not seek to create a class exclusive to the small superannuation fund. The level of taxation preferences available to a small superannuation fund would therefore depend upon its ability to come within one or more of the broader superannuation fund taxation categories. That outcome was consistent with the policy to extend taxation concessions to a range of superannuation funds, provided that they satisfied the various qualifying conditions in the tax law.

Although a concessional taxation treatment supports their existence, the underlying driver to specifically identify SMSFs and their predecessor small superannuation funds has been the emergence of prudential regulation. While the OSSR played a transitional role, the principal enactment has been the SISA. In this context, the definition of an ESF and the later SMSF were introduced as a means of providing modification to the prudential requirements that were applicable to other regulated superannuation funds. Since the adoption of these definitions statistical data has confirmed that their number and assets under management have grown substantially. Statistics also reveal that although the definitions have permitted up to four members, the most typical configuration has been one or two members.

The justification for adopting a less onerous application of prudential regulation to small superannuation funds appears to have evolved over time. During the period when the ESF

[147] Figure 4 is based on published and unpublished data collated by ATO.

definition was adopted, the unique approach was based on the members having a close association with the operation of the fund. Yet this was based on a perceived understanding of the types of member participation rather than any definitional requirement. Upon the adoption of the SMSF definition the justification for a limited application of SISA was based upon the fund being truly self-managed. That approach was supported by the definitional requirement to use a trust structure, with all members being trustees or directors of a corporate trustee. The intention was to mitigate the need for regulatory assurance by ensuring that each member was fully involved and had the opportunity to participate equally in the decision making processes of the fund.

However, whether the definitional requirement to adopt a trust structure was important to ensure that members participate in decisions of the SMSF and so justify a less restrictive regulatory approach raises some uncertainty. In particular, this follows from the deliberations in the Cooper Report, which reasoned that the reduced prudential regulation of SMSFs was appropriate because their members had assumed ultimate responsibility for their retirement savings and should be able to conduct themselves free of Government intervention. That is, if the assumption of control and acceptance of responsibility for SMSF decisions by its members justifies the modified regulatory approach under the SISA, has the role of the trust been overstated? This issue is subject to further consideration in Chapter 4.

CHAPTER FOUR: DECONSTRUCTING THE SMSF TRUST

4.1 Introduction

The less onerous regulatory approach of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) to the self-managed superannuation fund (SMSF) in comparison to other regulated superannuation funds was canvassed in Chapter 3 of this thesis. The origins of this differentiation was to reflect the purpose of the SISA restrictions in their application to the excluded superannuation fund (ESF), namely to ensure that the taxation concessions to which they were entitled were genuinely used for retirement income purposes rather than focussing on prudential objectives.[1] This explanation is equally applicable to the SMSF and continues the view that, whilst there is a need for regulation in light of their tax concessional status, the nature of such regulation should be less concerned with prudential restriction to protect the interests of members.

A key reason for adopting this narrow regulatory approach is that, unlike other regulated superannuation funds, SMSF members have chosen to self-manage their superannuation retirement income arrangements. Accordingly, unless a highly paternalistic view of regulation is adopted, it follows that SMSF members should not be prudentially protected from the actions that they themselves undertake for their own benefit as trustees. In this context, the role for SMSF legislative restriction should be singular and clear. Its objective is simply to offer individuals who choose the self-management option a trade-off between submitting to behavioural restrictions in return for a concessional taxation treatment of retirement savings. These restrictions protect the Government revenue interest by preventing inappropriate use of the taxation concessions available to regulated superannuation and, in light of its default role as the provider of old age pensions, provide some mitigation against the risk of failure.

Notwithstanding different regulatory objectives, SMSFs and other regulated superannuation funds share the same requirement to adopt a trust structure.[2] Accordingly, subject to the statutory prescriptions under the SISA, a SMSF trustee is subject to the general law duties applicable to trustees. Yet whilst acknowledging the unquestionable relevance of the trust, there is a surprising lack of analysis considering whether the trust framework is in fact suitable for the SMSF context. This question can be partially answered by reference to the eroded significance of the trust for regulated superannuation in general. However, a focus on the particular attributes of the SMSF enables a definitive conclusion that the trust as a legal vehicle does not accurately reflect the substance of the SMSF. Consequently, the paternalism

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1 Insurance and Superannuation Commission, Superannuation Circular No III.E.1: Excluded Superannuation Funds (1994) [8].

2 SISA s 19.

and core incidents of trusteeship that may be suitable for other types of regulated superannuation prove inept for the SMSF. Although a fall back to trust-related precedent provides a level of comfort, it does not fit easily with the statutory SMSF construct.

This chapter aims to fill the analytical gap. It considers the suitability of the trust framework at two levels. The first strand of analysis considers the broad suitability of the trust architecture upon which regulated superannuation, including the SMSF, currently relies. In this regard, the dynamic nature of superannuation is shown to have evolved into something that is difficult for the trust to maintain its grasp. The second strand of analysis considers the more specific fiduciary and trust law duties arising under general law that follow the adoption of a trust framework. The suitability of those duties needs to be considered in light of a trustee's obligations under the SISA, which prevail over any inconsistent general law obligation.[3] It is also important to consider the SMSF context in which they would be applied, particularly when the substance of the arrangement is accepted as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. Given that the remoteness of the trust to that characterisation, it is difficult to maintain that general law duties applicable to trustees are suitable, beyond perhaps an interpretative role as a particular case may require, alongside other relevant guidance.

Ultimately, the conclusion drawn is that the suitability of the trust framework for regulated superannuation is easily overstated. More definitively, in the specific SMSF context it is unsuitable. When considering the general law applicable to SMSF trustees, it follows from the adoption of the trust framework that fiduciary duties necessarily ensue. However, the scope for their contribution is somewhat muted given the existence of the SISA. Their suitability is also questionable when the analysis accepts the substance of the SMSF. In relation to trust law, there is difficulty in determining the extent to which the SMSF trustee covenants in the SISA (covenants) have adopted or been influenced by those principles.[4] Assuming that matter could be resolved, the concern remains that trust law is in any event inappropriate for the SMSF context. Although it is difficult to argue that the core incidents of trusteeship are wholly unsuitable for regulated superannuation funds in general, the SMSF, it is argued, presents a novel creation that arguably would be better served through a new approach. In this regard, suggestions to better accommodate the objective of SMSF members as investors to

3 SISA s 52 (as enacted) was the original location of the covenants. The covenants were recently subject to amendment and relocation within the SISA. For a SMSF they are located in SISA ss 52B, 52C to separately address a non-corporate or corporate trustee structure. However, apart from this change in location the substantive context of the covenants for the SMSF has essentially remained the same.

4 SISA ss 52A, 52B.

save for retirement within a concessional taxation environment is addressed in Chapters 5 and 6.

4.2 The SMSF in context

4.2.1 The trust framework

Aside from retirement savings accounts (RSA)[5] and schemes consisting entirely of policies of life insurance, superannuation in Australia is typically provided through a regulated superannuation fund. It is a SISA requirement that all regulated superannuation funds, including SMSFs, operate through a trust structure.[6] Whilst Chapter 2 considered the broad nature of a superannuation fund, in narrowing the analysis to the regulated superannuation fund it is useful to address the legal nature of the trust that provides the structure for these vehicles. Without addressing the well-known definitional uncertainties,[7] a trust can be described to exist:[8]

> … when the owner of a legal or equitable interest in property is bound by an obligation, recognised by and enforced in equity, to hold that interest for the benefit of others, or for some object or purpose permitted by law.

A regulated superannuation fund constituted by a trust must therefore have a trustee who holds legal title to the trust property, which is held for the benefit of the member beneficiaries and is vested in the trustee. This feature underscores a key trust characteristic: duality of ownership – as between legal and equitable title – in trust property. The consequence of this principle is that, under general trust law, a regulated superannuation fund cannot exist with a single person as the sole non-corporate trustee and beneficiary, due to the extinguishment of the trust through merger of legal and equitable interests.[9] Although that situation is unlikely to concern larger regulated superannuation funds, such as retail or industry funds, it is significant for the SMSF. It means that the large number of single member SMSFs must also

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5 A retirement saving account is a non-trust superannuation structure that operates pursuant to the *Retirement Savings Accounts Act 1997* (Cth). It is offered by certain financial institutions and life insurance companies to provide superannuation benefits upon death, retirement and in other limited circumstances.

6 SISA s 19.

7 Patrick Parkinson, ‘Reconceptualising the Express Trust’ (2002) 61(3) *Cambridge Law Journal* 657.

8 Dyson Heydon and Mark Leeming, *Jacobs’ Law of Trusts in Australia* (LexisNexis, 8th ed, 2016) [1-01] (footnotes omitted).

9 *Re Douglas* (1884) 28 Ch D 327, 331 (Pearson J). As also discussed, in the context of a SMSF the SISA overcomes this fundamental principle through permitting the adoption of a corporate trustee.

adopt a corporate trustee structure or otherwise have two trustees in order to accommodate the requirements of trust law.[10]

The character of a regulated superannuation fund can be further refined, in that it is established by deed, and therefore comes within the sub-species of express trust. The basic premise of such trusts is that the intention of the settlor as to the operation of the trust is reflected in the trust deed, though subject to certain fundamental trust obligations that cannot be displaced.[11] Amongst other matters, the trust deed may be expected to cover matters such as the duties and powers of the trustees, the interests and rights of beneficiaries and the procedure for winding up the trust. Disputes over these and related matters have given rise to a significant body of trust case law, providing a broad regulatory foundation for the conduct of a regulated superannuation fund and remedies to protect the interests of beneficiaries. Unsurprisingly, these types of cases are typically not SMSF-specific, given the unlikelihood of actions being brought by SMSF members who either alone or with no more than three others control the decisions of the fund.

Beyond the broad description of a regulated superannuation fund as a type of express trust, detailed scrutiny of its features reveals some difficulty in adopting this characterisation without further elaboration. Additional explanation is necessary to highlight a departure from the more traditional features and applications of the trust. Particular consideration may be given to various matters, which largely reflect the impact of government policy and the attraction of taxation concessions to increase participation, including:

- Whilst it is possible that beneficiaries of early superannuation schemes were volunteers, regulated superannuation now arises from a combination of consideration provided by beneficiaries as part of their remuneration, through personal contributions and statutory obligation. In the modern context, the characterisation of a beneficiary as a volunteer and the concept of a settlor acting out of bounty, from which much of trust law is derived, has no application.[12]

- To the extent that the superannuation is a product of employment or statutory prescription, there is a clear point of difference from a traditional trust where there is no relationship other than donor and donee. This has significant implications for the

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[10] SISA s 17A(2)(b).
[11] *Armitage v Nurse* [1998] Ch 241, 253 (Millett LJ).
[12] Nicolas Browne-Wilkinson, 'Equity and its Relevance for Superannuation Today' (Paper presented at the Superannuation 1992 National Conference for Lawyers, Canberra, 27-29 February 1992) 1.5.

construction of powers conferred by the trust, in that it is inappropriate to apply traditional trust law principles whereby a settlor can limit his bounty as he or she thinks fit by retaining, or conferring on others, such powers as he or she wishes.[13]

- In the case of a traditional trust, the size of the fund is normally defined from the outset; apart from investment, its quantum is not dependent upon the discretion of any third party.[14] This can be contrasted to a regulated superannuation fund, which can exhibit significant variability in size, particularly following the introduction of benefit portability. Although the SMSF is limited to four members, subject to that parameter the size of the fund is also variable.

- The beneficiaries of a traditional trust do not typically have any right to become or appoint trustees. In contrast, there are particular statutory rules applying to regulated superannuation funds to ensure member representation.[15] In the more "extreme" case of an SMSF, statute actually *requires* that all members be trustees or directors of the corporate trustee.[16]

These features combine to give a regulated superannuation fund a unique existence in terms of any characterisation by reference to the trust. The peculiarities of the SMSF conspire to make this uniqueness the more pronounced. Nonetheless, given the SISA requirement for a regulated superannuation fund to adopt a trust structure, it necessarily ensues that courts continue to uphold the relevance of trust law to their regulation.[17] Accordingly, there is no doubt as to the current relevance of the trust framework to the SMSF under the SISA; the same cannot, however, necessarily be said of its suitability for that purpose.

When addressing the suitability of the trust framework adopted by the SISA for the SMSF, it is important to consider the context in which that structure is employed. Adopting an accepted approach to construction for express trusts, a starting point to determine the suitability of the trust is to give due regard to the language of the parties, construed in appropriate context to take into account the matrix of circumstances that the parties intended.[18] However, significant

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13 Nicolas Browne-Wilkinson, 'Equity and its Relevance for Superannuation Today' (Paper presented at the Superannuation 1992 National Conference for Lawyers, Canberra, 27-29 February 1992) 1.6.
14 Nicolas Browne-Wilkinson, 'Equity and its Relevance for Superannuation Today' (Paper presented at the Superannuation 1992 National Conference for Lawyers, Canberra, 27-29 February 1992) 1.8.
15 Refer SISA Part 9.
16 SISA s 17A(1)(d).
17 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 272 (FC).
18 *Brynes v Kendle* (2011) 243 CLR 253, 288 (Heydon and Crennan JJ); *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107, 121 (Mason CJ and Wilson J).

context can also be ascertained from the fact that, besides the unique features of the SMSF, it is a type of regulated superannuation under SISA. These vehicles have been endorsed by Government to form part of a retirement income system. For this reason, the range of considerations to be taken into account is broader than other types of express trust and invites further analysis.

4.2.2 Erosion of the trust framework

In light of the SISA requirement for a regulated superannuation fund to adopt the trust framework it is indisputable that the trust is relevant to the SMSF. Theoretically the level of contribution by the trust could range from all the incidents of trusteeship arising under general law to merely precluding the adoption of other legal structures. Within these extremes, there is reason to suggest that the trust makes a substantive contribution. This is supported in case law by the conclusion that there is "no reason for holding that different principles apply to pension fund trusts from those which apply to other trusts".[19] That statement is no doubt correct from the basic notion that general law principles relating to the trust will apply to both superannuation and non-superannuation trusts, as both are constituted by a trust.

However, beyond generalisation there are clear points of difference in the manner and extent to which trust law principles apply. Thus, at a more detailed level, case law has recognised that different criteria might apply to the operation of a superannuation trust from those applicable to discretionary decisions made by a trustee under a non-superannuation trust.[20] Of further importance to the SMSF, there is acceptance that some aspects of trust law desirable for large pensions schemes may plainly be impracticable or undesirable (or both) in the case of a small fund.[21] These considerations reflect the impact of context and the distinctions that can be drawn having regard to the features of the vehicle in question.

Pursuing this approach, the initial focus is to consider the attributes of regulated superannuation in order to gauge the broad suitability of the trust framework and then overlay the unique features of the SMSF, as a particular vehicle within that class. In examining the context of regulated superannuation, the Australian approach has broadly followed English authority that pension schemes have certain characteristics that tend to differentiate their

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[19] *Cowan v Scargill* [1985] Ch 270, 290 (Megarry VC).
[20] *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 271 (FC).
[21] *Cowan v Scargill* [1985] Ch 270, 289 (Megarry VC).

deeds from other analogous instruments.[22] These require pension scheme documents to be construed in light of their background facts or surrounding circumstances, conveniently described in the language of Lord Wilberforce as their "matrix of fact".[23] The particular features identified by the English cases include: the fact that the beneficiaries under a pension scheme are not volunteers but have rights with contractual and commercial origins; that pension scheme documents are to be construed in light of the requirements of the Inland Revenue and statutory requirements; that the relevant background facts or surrounding circumstances include common practice from time-to-time in the field of pension schemes generally; and that temporary and imprecise documents should not be construed so strictly as to undermine their effectiveness.[24]

These principles were applied in Australia by the High Court in *Finch v Telstra Super Pty Ltd*[25] (*Finch*), the substance of which draws support from various aspects of *context* pertaining to regulated superannuation. Aside from factual matters concerning the parties involved, a very important point of context in *Finch* arose from the fact that the deed in question dealt with employee superannuation.[26] Accordingly, it was acknowledged that superannuation was a component of employee remuneration and represented a form of deferred pay. Further context was derived from the public significance of superannuation.[27] In particular, reference was made to the importance to citizens of making provision for their retirement by investing in superannuation. Their Honours observed that this objective was promoted through legislative requirements for employers to contribute a percentage of the employee's salary for this purpose. Another matter of context derived from the fact that superannuation funds have increasingly come under detailed statutory regulation.[28] In that regard, arguably the most significant intervention has been the SISA, which introduced prudential measures to strengthen the security of superannuation savings and protect the rights of members.[29]

Building upon the approach in *Finch*, the identified areas of context can be considered in greater detail to produce a thorough understanding of the trust framework as it applies to

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22 *Ansett Australia Ground Staff Superannuation Plan Pty Ltd v Ansett Ltd* (2002) 174 FLR 1, [215]-[216] (Warren J); *Mettoy Pension Trustees Ltd v Evans* [1990] 1 WLR 1587, 1610-1611 (Warner J); *Stevens v Bell* [2002] PensLR 247, 253-256 (Arden LJ).

23 *Mettoy Pension Trustees Ltd v Evans* [1990] 1 WLR 1587, 1610.

24 *Mettoy Pension Trustees Ltd v Evans* [1990] 1 WLR 1587, 1610-1611; *Stevens v Bell* [2002] PensLR 247, 253-256; *Brynes v Kendle* (2011) 243 CLR 253, 289; *Ansett Australia Ground Staff Superannuation Plan Pty Ltd v Ansett Ltd* (2002) 174 FLR 1, [216].

25 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 270-272.

26 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 271 (FC).

27 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 271 (FC).

28 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 272 (FC).

29 Explanatory Memorandum, Superannuation Industry (Supervision) Bill 1993 (Cth) 1.

regulated superannuation and more narrowly to the SMSF. The analysis supports a conclusion that the broad effect of context is to erode the suitability of the trust framework for regulated superannuation. The trust framework is particularly unsuitable when consideration is given to the peculiarities of the SMSF. To the extent that the trust framework is not suitable, there is logic in concluding that the presumed fiduciary and trust law duties following the adoption of the trust are correspondingly unsuitable. That view is substantiated by further analysis contained in this chapter.

4.2.2.1 Erosion of trust – employment context

In comparison to the ancient history of the trust,[30] even the earliest superannuation schemes in Australia are a much more recent phenomenon. Given the significant pre-existing body of trust law and discretionary nature of early superannuation schemes, the trust provided a convenient structure to adopt. However, even at this point it soon became clear that the trust context was only one aspect of superannuation. Beyond the trust, another factor influential on the receipt of superannuation benefits was the existence of an employment relationship.

The true importance of the employment context to regulated superannuation and the extent to which it has eroded the suitability of the trust framework requires some temporal analysis. In this regard, the existence of an employment relationship was often a prerequisite to membership of early superannuation funds and ultimately receiving superannuation benefits. However, beyond that contribution it was likely to have had limited significance. This is because the true intention behind many early schemes was to create a superannuation fund with maximum flexibility in decision making. That objective was accommodated by the trust, enabling separate administration of the scheme from the day-to-day operations of the employer and limiting control by those employees comprising its membership.[31] The unequal bargaining positions and loss of potential superannuation benefits upon termination explains why the employment relationship, though relevant, did not erode the overriding importance of the trust framework.

Developments in industrial relations subsequently transpired, which improved the bargaining power of employees, such that superannuation became a more reliably expected outcome from the employment relationship. Thus, an employee would individually or collectively bargain with their employer for contributions to be made on their behalf, having the economic

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[30] Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) 93.

[31] Richard Nobles, *Pensions, Employment and the Law* (Oxford University Press, 1993) 10, 13.

function of being part of the reward for services.[32] Accordingly, at this later point superannuation could increasingly be explained by reference to its employment context rather than the trust. While the nature of the employment relationship has continued to evolve, modern day case law has continued to maintain that the employment context is a relevant consideration when interpreting the trust deed of a superannuation fund.[33] This follows from the fact that the predominant way that citizens obtain reward for their knowledge and skills is through entering into contracts of service with an employer.

But the extent to which the employment relationship is a relevant consideration to a modern day regulated superannuation fund does require clarification before extrapolating that its importance has eroded the suitability of the trust framework. In particular, it is important to acknowledge significant legislative intervention has occurred in this area through the introduction of the Superannuation Guarantee (SG).[34] The scheme introduced a mandatory minimum level of superannuation contributions to be made by employers in respect of their employees and extended coverage to persons that were not employees within the common law meaning of that term.[35] For these persons the compulsory nature of the SG means that, at least up to the prescribed statutory minimum, regulated superannuation is more accurately a product of legislative prescription rather than employment negotiation.

The contribution of the employment context to regulated superannuation is also limited in that it does not explain the existence of voluntary contributions. In this regard, all members can make voluntary non-concessional contributions to a regulated superannuation fund.[36] In some instances these are partially matched through a scheme of government co-contribution.[37] Although these types of contribution are subject to legislative restrictions, these requirements do not prescribe that the member must be employed. At best, the employment relationship might indirectly, along with other sources of earnings, provide the resources to enable such contributions to be made. In the case of a self-employed person making concessional contributions to a regulated superannuation fund, the employment relationship is completely irrelevant. In both instances, the fact that members voluntarily make contributions suggests

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32 Refer discussion *Sayseng v Kellogg Superannuation Pty Ltd* [2003] NSWSC 945, [59] (Bryson J); *Dillon v Burns Philp Finance Ltd* (Unreported, Supreme Court of New South Wales, Bryson J, 20 July 1988) 14.

33 *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 271 (FC).

34 Refer *Superannuation Guarantee (Administration) Act 1992* (Cth).

35 *Superannuation Guarantee (Administration) Act 1992* (Cth) s 12 (definition of "employee"). Refer Australian Taxation Office, Superannuation Guarantee Ruling SGR 2005/1 Superannuation Guarantee: who is an employee? (2005).

36 The ability to make non-concessional contribution is subject to an age restriction of 75 years. Refer *Income Tax Assessment Act 1997* (Cth) ss 292-85(2), 290-80, 290-165.

37 *Superannuation (Government Co-contribution for Low Income Earners) Act 2003* (Cth).

that regulated superannuation owes its existence due to other reasons. The statutory basis of regulated superannuation provides explanation, in that investment occurs due to its concessional taxation under the *Income Tax Assessment Act 1997* (ITAA1997).

In applying these considerations to the SMSF, it seems that the employment context, though of continuing relevance, is even less significant. That conclusion is likewise supported by a temporal analysis. While statistics do not enable a clear factual statement, it appears that small superannuation funds have historically been utilised by two main types of person. The first category was self-employed persons in small businesses that were ineligible to join occupational superannuation funds existing for those in an employment relationship. The second type of persons were those who wished to make further provision for retirement separate and beyond what was possible through employment negotiation. In both instances, the employment relationship was remote to the existence of a small superannuation fund and would not provide a sound basis to erode the suitability of the trust.

Applying the early position of small superannuation funds to the SMSF does, however, need some elaboration. Whilst self-employed persons may have historically encountered difficulty joining occupational superannuation funds, the growth in retail superannuation funds means that the SMSF can no longer be characterised as the default option for the self-employed. The ability to adopt cost-effective corporate structures may in any event have led to many self-employed persons choosing to become employees, yet also continuing their SMSF membership. Furthermore, increased competition between occupational and retail superannuation funds is likely to result in greater flexibility to allow or encourage members to make additional superannuation contributions, removing the need to establish an SMSF for that purpose. On this basis, it would be incorrect to say that the SMSF lacks an employment context or that many SMSF members are not in many instances also employees.

The employment context is nonetheless less significant to the SMSF in comparison to other regulated superannuation funds. This is because the statutory basis of the SMSF assumes an even greater importance. Beyond the statutory intervention to create the SG and existence of voluntary contributions, the SMSF is a statutory construct that enables members to self-manage their retirement income arrangements. Though in the form of a trust, its substance is a mechanism for self-directed member investment. It is encouraged through taxation concessions but limited by SISA-prescribed restrictions. Members' ability to control investment decisions within a tax concessional environment is the overriding reason that the SMSF exists and has membership, irrespective of whether those members are employed, retired or self-employed. The overriding importance of investment is considered further under the broader financial context of regulated superannuation, as explained below.

4.2.2.2 Erosion of trust – financial context

Chapter 2 of this thesis made reference to the contribution of the 1997 Financial System Inquiry Final Report[38] (Wallis Report) to the development of the eventual SMSF structure. More broadly, the conclusions drawn in the Wallis Report provide evidence of the financial context of regulated superannuation in which members have come to be increasingly viewed as investors. The Wallis Report proceeded on the basis that the proper characterisation of beneficiaries involved in regulated superannuation was no longer one of vulnerability, in which members clung to the incidents of trusteeships at general law to protect their interests.

The eroded suitability of the trust framework for regulated superannuation funds was evident in the language used in the Wallis Report, referring to members not as beneficiaries but "consumers". Consistently, a regulated superannuation fund was not referred to as a trust but described as a "product". The discussion and recommendations contained in the Wallis Report viewed consumers of these products as empowered and actively pursuing their self-interest, ultimately leading to improved competition and market efficiency.[39] That approach reflected the growing importance of regulated superannuation to the Australian economy and the overriding objective that it operate efficiently. It reflects a departure from the trust characterisation of a regulated superannuation fund as simply one particular application of the trustee-beneficiary relationship.

The importance to the Wallis Report of the financial context to regulated superannuation and the eroded the suitability of the trust framework did not, however, mean that the interests of members should go unprotected. Indeed, a corollary of being described as a "consumer" is the expectation that consumer protection laws would exist to provide recompense for products, including superannuation, that are not as described in their disclosure statement. On this point the Wallis Report needed to strike a balance between a level of protection for superannuation members and the resultant impact on market efficiency; the latter would inevitably suffer were regulatory laws to interfere with decisions regarding the allocation of risk.[40] Whilst

[38] Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997).

[39] Scott Donald, 'What's in a Name? Examining the Consequences of Inter-legality in Australia's Superannuation System' (2011) 33 *Sydney Law Review* 295, 309.

[40] Gail Pearson, *Financial Services Law and Compliance in Australia* (Cambridge University Press, 2009) 451.

affording members a degree of protection, that line of enquiry is distinguishable from what would be expected from a trustee of an express trust making decisions in the interests of their beneficiaries.

Beyond the need to consider the broader impact of regulation on market efficiency, comments in the Wallis Report also implied difficulties with the trust framework at a more detailed level. In particular, it was noted that consumer protection becomes challenging when products, such as superannuation, fall into what the Report described as investments that "provide a return to investors based on their bearing a share of the risks which are intrinsic to financial activity".[41] That statement implies that members of a regulated superannuation fund are not only consumers but can be more precisely characterised as "investors". Since the nature of investment necessarily involves an acceptance of risk, the financial context of regulated superannuation would support the proposition that member protection should not alleviate the consequences of market based performance risk. Whilst this approach does not seem different to investments made through a non-superannuation investment trust, the distinction to be made for regulated superannuation is that the emphasis is placed on the member as the investor, rather than the trustee as the investor on behalf of the member.

Support for the characterisation of regulated superannuation fund members as investors is particularly evident from the growing prevalence of member investment choice. This increasingly common feature offered by regulated superannuation funds is reflective of market competition for investor savings rather than any legislative requirement.[42] In relation to trust law, a member's ability to direct how his/her superannuation interests are invested creates an unusual role for a trustee who must necessarily act in accordance with the member's direction. This somewhat uneasy predicament erodes a core incident of trusteeship, that the trustees carry responsibility for determining the investment of trust assets.[43] Nonetheless, such an outcome seems entirely consistent with the financial context of regulated superannuation in which the member is an investor bearing the consequences of market based risk. Taken to its extreme, a trustee would be left with the very limited role,

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41 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 251.

42 In relation to investment choice refer SISA s 52B(4), SISR reg 4.02 (concerning direction to a SMSF trustee); SISA s 58(1)(d), SISR reg 4.02A (concerning direction to a trustee of a registrable superannuation entity other than a regulated superannuation fund with fewer than five members); SISA s 31(1), SISR reg 4.02AA (concerning direction to a trustee of a regulated superannuation fund with fewer than five members that is not a SMSF).

43 Refer Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [49]. APRA's view is that a trustee is not relieved from the duty to act prudently, nor can it divest its duty to have regard to diversification, risk, liquidity and other factors when setting investment strategies.

almost akin to that of a bare trustee, of ensuring that members' decisions are implemented as directed, without considering the appropriateness of the investment choice.

Beyond member investment choice, the characterisation of regulated superannuation fund members as investors is reinforced through legislative intervention to enable members to determine which regulated superannuation fund will manage their superannuation interests, known as superannuation fund choice.[44] This intervention aimed to continue the approach endorsed by the Wallis Report to improve returns through increased competition and efficiency in the superannuation industry.[45] But that objective was also necessarily predicated on a recalibration of the trust relationship, in particular, on increased participation by members to choose from a range of investment products. Once again, the empowerment of members to make decisions that circumvent both the trustee and the trust itself provides further evidence to erode the suitability of the trust framework for regulated superannuation.[46]

It is evident from these observations that financial context of regulated superannuation makes a major contribution in demonstrating the unsuitability of the trust framework. However, in the SMSF context there is reason to suggest an even greater contribution. This is because while SMSFs and other regulated superannuation funds are both subject to the SISA, the restrictions on SMSF activity are less intrusive due to a range of exceptions. Although there are narrow explanations applicable to some exceptions,[47] it is also arguable that, given the substance of the SMSF, greater priority has been placed on their market efficiency than the need for regulatory interference to protect members. The position of the SMSF as a product can be distinguished from other regulated superannuation funds due to the heightened extent to which SMSF members can make investment decisions. The level of control exercised by SMSF members makes their position more comparable to individuals making private investment decisions, which from a regulatory perspective there is reluctance to intervene given the costs to market efficiency.

Implicit in this explanation of the financial context to the SMSF is that the importance of the SMSF member as an investor is greater than for other regulated superannuation funds. That is apparent from the substance of the SMSF as a mechanism for self-directed member investment. At the detailed level, the degree of control of SMSF members over their

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44 *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* (Cth).

45 Explanatory Memorandum, Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2004 (Cth) 5.

46 Refer section 5.2 of this thesis for discussion of the importance of the choice architecture.

47 For example, refer to section 3.3.1 of this thesis for discussion of the exception for SMSFs to invest in business real property. The exception was directed at enabling small business people to invest in their own business premises through their SMSF.

superannuation interests goes beyond investment choice or fund choice that may be available in other regulated superannuation funds. Whilst a member of a regulated superannuation fund may exercise control over a trustee by directing which investment category their superannuation interests shall be invested, the range of those categories has been determined by the trustee and is typically limited. Similarly, although the member may choose to switch to a different regulated superannuation fund, he/she remains subject to similar constraints. These constraints unavoidably dilute the investor-efficient market analogy for non-SMSF regulated superannuation members.

These observations suggest that financial context can accurately explain the substance of the SMSF and that the trust as a legal vehicle does not materially contribute to that explanation. The recognition of SMSF's members as self-directed investors explains why there is a reduced need for member protection in comparison to other regulated superannuation funds, wherein the role of the member may be escalated, though not to the same extent. Where regulation is required, the financial context suggests that a balance should be struck between protecting SMSF members from their own self-directed investment decisions (to the extent that in itself could be justified) and the impact on market efficiency. That approach must, however, be tempered by one further consideration. While the SMSF is a mechanism for self-directed member investment, its substance is also defined by the fact that it is concessionally taxed. The existence of these taxation concessions highlights that the SMSF has a public context, given that taxation expenditures are a matter of public interest.

4.2.2.3 Erosion of trust – public context

The historical analysis in this thesis demonstrated the continuing impact of government policy on regulated superannuation through a range of legislative measures. This ongoing interference reflects the fact that, aside from its legal form as a trust, regulated superannuation has a significant public context. That context is reflected through a range of factors, but is particularly affected by the historical decision to adopt a retirement income system that includes regulated superannuation encouraged through taxation concessions. The significance of taxation concessions provides a point of distinction between these vehicles and other non-superannuation trusts which, although may influence where the incidence of taxation falls, do not enjoy a similarly generous tax concessional treatment.[48]

[48] The existence of persons having a present or specific entitlement to trust income, franked distributions or capital gains will influence how the incidence of taxation falls. Refer Divisions 6, 6E ITAA1936, ITAA1997 Subdivisions 115-C, 207.

The amount of tax expenditure on supporting regulated superannuation impacts the amount of funding available for other pillars of the retirement income system and therefore draws a range of community views. The objectives and parameters under which regulated superannuation must operate are also influenced by the perceived level of public support for other completely unrelated political priorities. On this basis, reforms such as the taxation of fund earnings,[49] the superannuation surcharge,[50] the reduction in high income earner superannuation tax concessions[51] and lower superannuation contribution caps[52] are to varying degrees interrelated with competing priorities, such as balanced fiscal budgeting, education and social welfare reforms.

These considerations demonstrate the precarious nature of the taxation concessions for regulated superannuation and their susceptibility to change. Nonetheless, it would also seem that taxation expenditure on regulated superannuation continues to enjoy significant in-principle community support. One reason for this is that the SG system has forced a large section of the public to participate in regulated superannuation. These people are also joined by other citizens who voluntarily participate in regulated superannuation, further enlarging its coverage. In both instances, once these persons have accumulated an interest in regulated superannuation, self-interest motivates their opposition to legislative intervention diluting the level of taxation support their interests receive. However, beyond that broad proposition the degree of public support may fracture due to differences in the size of people's interests in regulated superannuation. Those variances raise questions about the equity of taxation expenditures for regulated superannuation, potentially causing more qualified public support and ultimately further legislative change.

It is also pertinent to observe that the public context of regulated superannuation is not limited to taxation. The Government's policy objective for regulated superannuation is for it to provide the opportunity for people to enjoy a higher standard of living in retirement than if

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[49] ITAA1936 Pt IX inserted by *Taxation Laws Amendment Act (No. 2) 1989* (Cth). ITAA1936 Pt IX Division 3 provided a comprehensive code for the assessment of complying superannuation funds. In particular, refer ITAA1936 s 285 for standard component of a complying superannuation fund's taxable income, ITAA1936 s 284 for the special component of a complying superannuation fund's taxable income, ITAA1936 s 283 for the exemption of a complying superannuation fund's income attributable to current pension liabilities. *Income Tax Rates Act 1986* (Cth) ss 26(1)(a), (b) provided the tax rates of 15% and 49% for a complying superannuation fund.

[50] *Superannuation Contributions Tax (Assessment and Collection) Act 1997* (Cth).

[51] ITAA1997 Division 293, inserted by *Tax and Superannuation Laws Amendment (Increased Concessional Contributions Cap and Other Measures) Act 2013* (Cth).

[52] ITAA1997 ss 292-20(2)(c), inserted by *Tax Law Amendment (2009 Budget Measures No. 1) Act 2009* (Cth). This change lowered the concessional contribution caps from $50,000 to $25,000 for the 2010 financial year.

they relied on the old age pension alone.[53] Although taxation expenditures on regulated superannuation contribute to that objective, they provide no assurance that member interests are safe. In this regard, the public context broadly requires that trustees responsible for member interests in regulated superannuation be subject to prudential regulation. While it is possible to make some broad correlation between this context and the paternalism of trust law, the public context's concern for member interests is more accurately reflected in the SISA-prescribed restrictions on trustee behaviour.

The importance of the public context to regulated superannuation that members' interests are safe is evident in the SISA's formulation, through Government statements reiterating that no investment is more special than superannuation and that the security of superannuation is most important to all Australians.[54] Upon SISA's enactment, the importance of enhancing the safety of member interests was apparent through a range of provisions, particularly those that: defined the rights of members; required equal member and employer representation for funds with 200 or more members; enhanced disclosure of information to members; established dispute resolution arrangements; created arrangements for unclaimed benefits and procedures for replacement of representative trustees and financial assistance in the event of fraud.[55] These measures were designed to assist members to protect their retirement savings and enhance their ability to influence decisions made by trustees.[56]

To some extent, the identified matters of public context relating to regulated superannuation generally are applicable to the SMSF. Support of taxation expenditures for SMSFs is reflected in the fact that there are no substantive differences in the taxation law applying to SMSFs and other regulated superannuation funds. That said, there are features of SMSFs that may generate increased taxation benefits, including that SMSFs on average tend to have higher member account balances.[57] This in turn suggests that SMSF members on average receive a larger share of tax expenditures on regulated superannuation than the majority of the public who are not SMSF members. A further matter relates to changes from the member

53 John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 1.
54 John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) iii.
55 John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 12-18, 32-33.
56 John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 12-13.
57 As at 30 June 2015 the average account balance for a SMSF member was $562,000, significantly exceeding an average account balance of $42,000 for other APRA regulated superannuation funds. Refer Australian Prudential Regulation Authority, 'Statistics' [2015] (June) *Annual Superannuation Bulletin* 7.

accumulation to pension phase, where administrative complexity for large regulated superannuation funds often means that a capital gains tax liability will be crystallised for that member. The same difficulty would not be expected to arise for a SMSF member because administration is relatively straightforward and members can more easily decide when a particular asset will be sold. Due to these and other perceived taxation advantages, the public context supporting tax expenditures for regulated superannuation remains applicable to the SMSF, but is more susceptible to being qualified. In this regard, implementation of the Government's 2016/17 Budget[58] to now limit member pension phase accounts to $1.6 million would tend to restrict capital gains from falling within exempt current pension income for larger member accounts.[59]

A further distinction between the public context of regulated superannuation and the SMSF relates to prudential regulation. The broad public context of regulated superannuation places significant importance on the safety of member interests, consistent with the public expectation that those in charge of managing investments held for a member's retirement must be accountable for their conduct, including trustee responsibility for setting the parameters of member direction. But this logic does not easily translate to the SMSF, since its members have chosen to self-manage their retirement income arrangements. Accordingly, the public context is not concerned with providing assurance to members that their SMSF interests are safe, since the safety of those interests is in substance determined by investment decisions made by those same members.

Yet the decision to self-manage one's retirement income arrangements through the SMSF does not mean that the public context has complete disregard for SMSF member interests. In the extreme, a complete failure of the SMSF sector would raise significant public concern due to likelihood of increased claims on the old age pension. The point of distinction is that the public interest is one of collective self-interest that the public will have to pay for poor SMSF investment decisions, rather than any need to assure individual SMSF members that their interests are safe. Thus, a better explanation of the public context to the SMSF is that it is indirectly concerned for member interests. It seeks assurance that the taxation concessions to

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[58] Commonwealth of Australia, *Budget 2016-17, Budget Measures, Budget Paper No. 2* (2016) 25-26. The ALP's 2016 election policy on superannuation was arguably more directed towards the disposal of assets by an SMSF during a member pension phase by proposing an earnings cap of $75,000. Subject to grandfathering arrangements, earnings derived from the disposal of a CGT assets would be included in the cap. The proposal specifically identified 24,000 SMSF funds with account balances of more than $2 million that had currently benefited from large pension phase tax free earnings. Refer Australian Labor Party, *Labor's Fairer Super Plan* <http://www.alp.org.au/fairer_super_plan>.

[59] Refer *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).

which SMSFs can access are properly used for retirement income purposes. Government has determined that this concern is sufficiently addressed where the SMSF complies with the restrictions contained in the SISA.[60] Their objective is, consistent with the Government's retirement income policy for regulated superannuation, for the SMSF to enhance the opportunity for people to enjoy a higher standard of living in retirement than if they relied on the old age pension alone.[61]

4.2.3 Difficulty in abandoning the trust framework

Though the trust is unquestionably relevant to regulated superannuation funds due to statutory prescription in the SISA, that conclusion does not determine its suitability. The suitability of the trust must be determined by reference to the context in which it is employed. In this regard, a range of contextual matters have been addressed to generate attributes that are absent in other types of trust. While not causing the SISA to depart from the trust framework, the context of regulated superannuation significantly expands the range of considerations to be addressed when examining the suitability of the trust and general law following the adoption of that structure. The most important consideration relating to the erosion of the trust framework stems from financial context, and points towards a significant recalibration of the trust relationship due to the enhanced capacity for member participation and influence over their superannuation interests.

The escalated role for members as consumers of superannuation products or even as investors has developed on the assumption that self-interest would cause members to take the opportunity to increase their involvement in regulated superannuation. However, given the difficulties in measuring member participation, it is unclear whether this has in fact occurred or is more theoretical. For example, an active decision by a member to remain in the same regulated superannuation fund or investment category might easily be misconstrued as disengagement rather than a conscious decision. Therefore, although there is a basis to resolve that financial context has eroded the suitability of the trust framework for regulated

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[60] Despite the evident conflicting contexts of member self-interest and public interest to mitigate increased reliance on the old age pension, this thesis does not critique the adequacy of the SMSF-related restrictions in the SISA to resolve such conflict. That is consistent with its scope accepting the basic policy settings for superannuation (refer section 1.5 of this thesis). Nonetheless, the conflict is addressed to a degree in section 6.2.2.3 of this thesis when discussing the case for portfolio controls. Where the public interest warrants further protection, such constraints might be included as part of reforms to the SMSF legal framework, though the matter is ultimately left open for further Government consultation.

[61] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 1.

superannuation, there is an understandable difficulty in reaching consensus that the trust should be abandoned.

Furthermore, the financial context of regulated superannuation does not exist in isolation. It is clear that the broad public context requires significant weight to be given to the safety of member interests. That is supported by the public expectation that those in charge of managing investments held for a member's retirement be held accountable for their conduct, but also a range of evidence suggesting poor standards of financial literacy in a significant section of the general public.[62] For these people, the paternalistic notions embodied in the general law duties of a trustee, particularly that trustees will act not for themselves but for the benefit of the beneficiaries remain appropriate. They bear resemblance to the SISA's prudential objectives and are therefore likely to enjoy continued support.

On this basis, although unsuitable in some respects, there is an understandable difficulty in attaining any broad consensus that the trust framework be removed for all types of regulated superannuation. But it does not necessarily follow from that conclusion that a specific case for exception cannot be made for the SMSF. That is due to the fact that the SMSF exhibits important differences from other types of regulated superannuation. Most significantly, the substance of the SMSF is unique, as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. Unless the SMSF context is given sufficient weight, there is a risk of falling back to generalisation, an approach that is unlikely to reflect the substance of what SMSFs are about.

4.2.4 Consequences for the SMSF

The impact of context demonstrates why the trust framework is, in many respects, unsuitable for regulated superannuation. The case to abandon the trust becomes more persuasive when the focus narrows to consider the particular circumstances of the SMSF. In that instance, financial context supports an extreme recalibration of the trust relationship due to the enhanced capacity for member participation and influence over their superannuation interests. Furthermore, the public context does not limit that recalibration through concerns for the safety of member interests in the same way that is does for regulated superannuation generally. It does not equate with the paternalistic notions embodied in the general law duties

[62] Australian Securities and Investments Commission, *Financial literacy in schools*, Consultation paper 45 (2003) 12; Australian Bureau of Statistics, *Adult Literacy and Life Skills Survey, Summary Results, ABS Cat no. 4228.0* (2006) (reissue 9 January 2008) 5.

of a trustee, but seeks assurance that the taxation concessions to which the SMSF is entitled have been properly applied for retirement income purposes.

In order to substantiate this position, it is useful to refer to early observations on the Excluded Superannuation Fund (ESF), the precursor of the SMSF. In considering the nature of these vehicles, the Wallis Report concluded that:[63]

> The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries...

These comments highlight that, from a regulatory perspective, ESFs were accurately characterised as a product for superannuation investors to directly manage their retirement savings. The approach reflects the high degree of involvement expected of members in all aspects of ESF activity. Accordingly, prior to the reforms that empowered members through superannuation fund choice and the proliferation of investment choice, the role of ESF members was such that the trust could not function in respect of any matter without member endorsement and acceptance of the regulatory consequences for non-compliant behaviour. The degree of member involvement was incomparable to any other form of regulated superannuation fund and incompatible with the fundamental nature of a trust. Whilst the heightened role expected of the ESF member justified the proposed regulatory approach, it also followed that the increased emphasis on the role of the member made it more difficult to sustain the suitability of the trust framework.

Consistent with the characterisation of the ESF as an option for the self-managed superannuation investor, the Wallis Report did not see a role for prudential mechanisms to protect those members' superannuation interests. The point of distinction arising from the fact that members chose self-management was that, unlike other regulated superannuation funds, there was in substance no responsible entity between members and their interests. That is, the members are the investors. The Wallis Report was clearly not persuaded that members should be protected through prudential measures from the actions that they themselves undertook for their own benefit, albeit technically in their capacity as trustees. Furthermore, even if the trust

63 Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 334.

form were recognised, rather than the substance of the arrangement, the Wallis Report considered it impractical to apply prudential regulation to the circumstances of the ESF.

Although the ESF has now been superseded by the SMSF, the views expressed by the Wallis Report remain instructive when addressing context. Yet it is also clear that they cannot be accepted without qualification, given that the SMSF as a regulated superannuation fund remains subject to the SISA, a prudential enactment. That said, it would be incorrect to conclude that as a regulated superannuation fund they simply fit within a SISA "one size fits all" prudential approach supporting a public context that regulated superannuation is successful and member interests are safe. Consistent with the views of the Wallis Report, the SMSF should be viewed in a different context to other regulated superannuation funds due to the fact that members have chosen to self-manage their retirement savings. While the choice to self-manage leads to greater control and flexibility over investment decisions aligned to a financial context, the further consequence is a reduction in the public concern for assuring SMSF members that their interests are safe. Instead, the public context of the SMSF is concerned with assuring the public that the taxation concessions SMSFs can access are properly used for retirement income purposes.

In light of these observations, the SMSF is accurately characterised as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. Consequently, it is difficult see a role for the trust framework to regulate a relationship that, when viewed in its proper context, does not in substance embody the trust. Support for this approach can, to some extent, be found in the 2010 Super System Review Final Report[64] (Cooper Report). Whilst ultimately recommending that the trust framework be retained for regulated superannuation, the Cooper Report drew distinctions between different types of regulated superannuation fund based on the level of member engagement. In this regard, at one end of the spectrum the Cooper Report identified members who chose to leave investment decision-making to a trustee.[65] The paternalism and protection implied by traditional notions of trusteeship were clearly accepted as being relevant to these members.[66] At the other end of the spectrum, the Cooper Report identified the members of an SMSF. It observed that these vehicles were for members wanting a tailored investment

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[64] Superannuation Review Panel, *Super System Review Final Report* (2010).

[65] MySuper is representative of this category.

[66] Scott Donald, 'What's in a Name? Examining the Consequences of Inter-legality in Australia's Superannuation System' (2011) 33 *Sydney Law Review* 295, 301.

strategy, who would consequently be vested with full responsibility for the consequences of the choices they make.[67]

Whilst the views of the Cooper Report support the conclusions in this chapter, it is suggested that rather than distinguishing between regulated superannuation funds on the basis of engagement, a better justification is made by reference to context. That a member might be engaged does not necessarily support a departure from the trust framework. For example, an individual may be highly engaged in their superannuation yet lack the time, ability or inclination to adopt a SMSF approach. The focus on context in preceding discussion has demonstrated there are objective and legally grounded reasons to question the suitability of the trust framework for the SMSF. What follows continues to stress the importance of context at a detailed level when considering the suitability of the more specific fiduciary and trust law duties that flow from the adoption of the trust. It shows the limited role of these duties in the SMSF context and accordingly serves to undermine a basis for retaining the trust framework.

4.3 The SMSF and fiduciary duties

4.3.1 Presumed fiduciary duties

One of the most fundamental implications arising from the SMSF's adoption of the trust framework is the presumed existence of fiduciary duties. In this regard, the connection between a trustee and beneficiary is recognised as the archetypal fiduciary relationship.[68] In the event that the SMSF adopts a corporate trustee, the position of company director presents a further relationship that is presumed to give rise to fiduciary duties. However, whilst enjoying broad acceptance, when scrutinised these presumptions do not necessarily provide a compelling basis for retention of the trust in this context. This stems from the fact that the presumptions do not extend themselves to specify which fiduciary duties they capture and thus apply to the SMSF context.

Without relying on the presumption that all trustees are fiduciaries, the substance of the SMSF as a mechanism for self-directed member investment does not easily align to the expected attributes of a fiduciary. The task is complicated by the absence of any generally accepted definition of what in fact constitutes a fiduciary.[69] Whilst informative, criteria such

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[67] Scott Donald, 'What's in a Name? Examining the Consequences of Inter-legality in Australia's Superannuation System' (2011) 33 *Sydney Law Review* 295, 301.

[68] Gino Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) [4.80].

[69] Paul Finn, 'The Fiduciary Principle' in Timothy Youdan (ed), *Equity Fiduciaries and Trusts* (Carswell, 1989) 1, 54.

as trust and confidence, undertaking to act in the interest of another or vulnerability are unable to provide a complete explanation. Indeed, the elusive nature of the term fiduciary has led some to resign to the conclusion that the term could more aptly be defined as a "concept in search of a principle".[70]

The significance of fiduciary duties ensuing from the SMSF's adoption of the trust framework requires further detailed analysis beyond presumption. The focus must examine the particular features of the SMSF rather than rely upon common attributes shared by trusts as a legal vehicle. This aligns with the earlier discussion that emphasised the uniqueness of regulated superannuation and particularly the SMSF in terms of any characterisation by reference to the trust. It is also consistent with the approach by Waddell CJ in *Lock v Westpac Banking Corporation*[71] who in a pension scheme context enquired, beyond the existence of fiduciary duties owed by a trustee to beneficiaries in a general sense, "what was the extent and nature of their fiduciary duties having regard to the terms of the deed and the circumstances to which it is directed".

Applying this approach, the analysis is less concerned with the presumptive fact that, since a SMSF is created by trust, fiduciary duties necessarily arise. Beyond that fact, the significance of those fiduciary duties as a reason to retain the trust framework requires examination of their content when applied to the SMSF context. To the extent that fiduciary duties have a limited role, then that fact that they are presumed from the trust is not a persuasive reason for retaining that structure. On this basis, the fiduciary duties are paramount, while the fiduciary presumption or use of the term fiduciary, unless applied in the context of those duties, is not instructive.[72] Although not completely aligned to this approach, Australian case law supports a duty-based analysis rather than drawing upon the more elusive concepts of fiduciary or fiduciary relationship.[73]

4.3.2 A duties-based approach

Proceeding on a duty-based approach, it is unfortunate that the task of exhaustively capturing what might form the basis of the SMSF trustee's fiduciary obligation is difficult. This follows from the propensity of courts to apply general terms and principles rather than a definitive list of duties. The adoption of general terms to express the fiduciary obligation means that those

70 Anthony Mason, 'Themes and Prospects' in Paul Finn (ed), *Essays in Equity* (The Law Book Company, 1985) 242, 246.
71 (1991) 25 NSWLR 593, 609.
72 Paul Finn, *Fiduciary Obligations* (Law Book Company, 1977) 1.
73 *Warman International Ltd v Dwyer* (1995) 182 CLR 544, 556.

terms, themselves, do not provide a direct benchmark against which to assess the propriety or impropriety of a particular fiduciary's actions.[74]

Despite its challenges, in order to assess whether fiduciary duties are suitable for the SMSF some attempt must be made at stating those duties. Whilst accepting that the precise content of the duties may vary in light of particular contractual terms[75] or legislative requirements,[76] Australian case law provides clear support that they include what are termed the "no-conflict rule" and the "no-profit rule".[77] That is, a fiduciary must ensure that they do not place themselves in a position of conflict with their duties, and must not make an unauthorised profit from their position. If either of these obligations is breached, the fiduciary must account for any profits or make good any losses arising from the breach.

Though it is debatable whether the no-conflict and no-profit rule exhaust a fiduciary's duties,[78] what seems clear is that they form a core part of the fiduciary obligation. On that basis, to the extent that these duties are inappropriate for the SMSF trustee, it is arguable that the fiduciary obligation should not apply at all.[79] The fact that trusts attract fiduciary duties would not upon detailed review provide a compelling reason to retain the trust framework, when in the SMSF context there is no significant content to those duties. While the focus on two duties may attract criticism as being overly simplistic, it avoids the unresolved debate concerning the scope and separate existence of other duties that are purported to be fiduciary in nature.

Finally, when examining the no-conflict and no-profit rule, it is surprising that despite their paramount importance in equity, neither rule was explicitly incorporated in the SISA.[80] Perhaps they were not duties that required any particular legislative clarification, or maybe the inherent uncertainty surrounding the fiduciary concept made the task too difficult. More likely, their exclusion reflects an acceptance by the legislature that in reality individual trustees of regulated superannuation funds could not reasonably be expected to act without

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74 Paul Finn, *Fiduciary Obligations* (Law Book Company, 1977) 15.

75 *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 97 (Mason J)

76 For example, SISA s 350.

77 *Breen v Williams* (1996) 186 CLR 71, 113 (Gaudron, McHugh JJ).

78 Robert Austin, 'Moulding the Content of Fiduciary Duties' in AJ Oakley (ed), *Trends in Contemporary Trust Law* (Clarendon Press, 1996) 159.

79 For discussion of the dilution of fiduciary duties in the superannuation context refer Pamela McAlister, 'The Changing Winds of Superannuation – Relief for Employers?' (2000) 11 *Journal of Banking and Finance Law and Practice* 100, 109.

80 Cf: Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) 104 recommended that the fiduciary obligations of responsible superannuation entities be set out in legislation.

some degree of conflict.[81] Similarly, it may have been accepted that the flexibility in the SISA concerning the ability of SMSF trustees to use and acquire fund property would have been unworkable with a co-existing legislative no-conflict or no-profit rule. Since the SISA's enactment neither duty has been inserted by way of amendment or otherwise clarified.

4.3.3 Duty to avoid conflict

When addressing the suitability of the no-conflict rule to a SMSF trustee, a useful starting point is the remark by an English judge that a strict application of the rule would see that "no man should be asked to exercise a discretion as to the application of a fund amongst a class of which he is a member".[82] The case law also reveals that a strict approach is liable to mislead because the no-conflict rule is riddled with exceptions.[83] One such exception is that the rule does not apply where the pension scheme rules specifically contemplate that employee members will act as trustees.[84] The basis for that modification is the general principle that the rules of equity were devised in order to produce fair and sensible results.[85] Without qualifying the no-conflict rule, the notion that when a discretionary power is exercised that increases an existing benefit or adds a new benefit, the member-trustees should be excluded, has been considered to be a ridiculous outcome.[86]

Against this background, the Australian Law Reform Commission, in a report (ALRC59) that provided much of the impetus for the SISA, was nonetheless satisfied that the no-conflict rule could make a useful contribution when recommending its inclusion as a core legislative duty.[87] Yet the SISA did not ultimately adopt that approach. Consistent with the difficulties identified in English case law, the unsuitability of the no-conflict rule for the regulated superannuation fund context is apparent from the SISA requirement that employer-sponsored funds have equal representation for members on trustee boards.[88] This requirement places member-trustees squarely at odds with the no-conflict rule, unless recourse is made to the identified exception when describing the content of that rule. Ultimately, recourse to that exception proves unnecessary as the SISA makes explicit that fiduciary law can only apply to

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81 Scott Donald, ''Best' Interests' (2008) 2 *Journal of Equity* 245, 263.
82 *British Coal Corporation v British Coal Staff Superannuation Scheme* [1995] 1 All ER 912, 925 (Vinelott J).
83 *Re Drexel Burnham Lambert Pension Plan* [1995] 1 WLR 32, 40 (Lindsay J).
84 *Edge v Pensions Ombudsman* [1998] Ch 512, 539-540 (Scott VC).
85 *Edge v Pensions Ombudsman* [1998] Ch 512, 539 (Scott VC).
86 *Edge v Pensions Ombudsman* [1998] Ch 512, 539 (Scott VC).
87 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) 111.
88 SISA Part 9.

a regulated superannuation fund to the extent that it is capable of operating concurrently.[89] In that regard, the SISA has, with or without consideration of fiduciary law, endorsed the importance from a regulatory perspective of having member-trustees so as to improve the ability of a regulated superannuation fund to give proper consideration to all relevant interests.

When the analysis narrows to consider the SMSF, the unsuitability of the no-conflict rule becomes even more apparent. In terms of representation, the SISA extends the requirement that members are merely represented to prescribing that all members must be trustees or trustee-directors. On that basis, it is not merely the case that some small percentage of members will be placed in a position of conflict with their position as trustee. The very nature of the SMSF ensures that *all* members are in that position. Active participation as a trustee in every SMSF decision is reinforced by the joint and severable regulatory responsibility of each member, suggesting a heightened propensity for conflict. At the same time, the fact that all members must be trustees or trustee-directors and participate in decision-making yields increased certainty that all interests will be properly considered. Accordingly, it is neither fair nor sensible that a rule of equity should intervene to disturb decisions that have been mutually agreed by all participants on the basis of conflict.

To reinforce this conclusion, it is useful to examine the nature of self-directed investment undertaken by an SMSF. Given the statistic that 92.5% of SMSF's were one or two member regulated superannuation funds as at 30 June 2015,[90] assume that by way of example a single member SMSF has made a decision to undertake some specified action. In that case any decision made by the trustee is in substance made by the member for his or her own benefit. Analysing whether a member obtained a benefit in the capacity as trustee in breach of the no-conflict rule, and whether the same person should be compensated in the capacity as member, is highly artificial. Furthermore, it is unlikely that a sane person in a member capacity would commence an action for recovery against himself or herself in the capacity as trustee. These observations are consistent with the public context of the SMSF, where the real point of conflict is between members as self-interested investors and the public who require assurance that the taxation concessions to which SMSFs can access are properly used for retirement income purposes, rather than a trustee-beneficiary conflict.

[89] SISA s 350.

[90] Australian Taxation Office, *Annual SMSF population analysis tables* (2016) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-statistical-report-June-2016/?anchor=Membershipsizes#Membershipsizes>. The membership composition for 30 June 2016 was not available at the time of writing.

The foregoing observations demonstrate the importance of giving sufficient consideration to the substance of the SMSF to avoid misstating the significance of the no-conflict rule. The identification of that substance has to date largely been unwilling to progress past the rudimentary conclusion that an SMSF is about members taking control of their own superannuation affairs. That characterisation is constructive to some degree, in that control over decision making might justify why the no-conflict rule assumes less importance, but it fails to fully describe the SMSF context. The precise characterisation of the SMSF adopted in this chapter – a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions – highlights that although as a matter of fact the no-conflict rule follows the adoption of the trust framework, it is also hollow, since in substance the SMSF is simply a legislative device to empower self-directed investment.

4.3.4 Duty not to profit

The difficulty of providing a succinct explanation of the no-profit rule is that, like the no-conflict rule, it tends to be expressed in general terms. Whilst there is no generally accepted formulation, one of the more familiar statements is articulated by Lord Halsbury in *Bray v Ford*: [91]

> It is an inflexible rule of a Court of Equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict.

In adopting this statement, it is apparent that there are two elements to the no-profit rule. The first is to prevent a person who has undertaken to act for or on behalf of another in some matter from allowing any undisclosed personal interest to sway him or her from the proper performance of that undertaking.[92] The second element is concerned with preventing a person from actually misusing the position his or her undertaking provides to further his or her own interests.[93] Although the basis for imposing this requirement upon fiduciaries can be variously expressed, an underlying reason is the danger that a person holding a fiduciary position might be swayed by interest rather than duty, thereby prejudicing those whom they must protect.[94] This explanation in turn tends to suggest the no-profit rule comes within the scope of the no-conflict rule.

91 [1896] AC 44, 51.
92 Paul Finn, *Fiduciary Obligations* (Law Book Company, 1977) 200.
93 Paul Finn, *Fiduciary Obligations* (Law Book Company, 1977) 200.
94 *Bray v Ford* [1896] AC 44, 51 (Lord Halsbury).

Whereas the no-profit rule was not specifically included in the SISA, there is a logical basis for its application to a regulated superannuation fund. This view was shared by ALRC59, which supported the rule's inclusion as a core legislative duty.[95] However, while this view may have merit as a matter of broad principle, it becomes somewhat more complex when subjected to a detailed examination of how the rule would actually apply. This is accentuated by the potential for the no-profit rule to contain significant inconsistency with the permitted actions of a SMSF trustee under the SISA.

Provided that a SMSF complies with the SISA, particularly the sole purpose test and other more specific restrictions, there is clear scope for transactions that cause a trustee to profit from the SMSF. The fact that these transactions may freely occur, and in some instances are specifically endorsed, reflects the overriding purpose of the SISA to ensure that the retirement income objective remains unqualified. In turn, that objective can be supported by whatever restrictions or flexibilities the legislature deems appropriate. Although there is similarity in their application, the no-profit rule being applied strictly and, say, the sole purpose test requiring exclusivity of purpose,[96] the distinguishing point is that their objectives differ.

Whilst elements of the no-profit rule can be found in the SISA, such as the requirement that a SMSF trustee must not be remunerated,[97] they have been adopted as part of a targeted range of legislative restrictions directed at furthering the retirement income objective. As the purpose of the no-profit rule does not necessarily align to the retirement income objective, it is understandable why it was not simply included as a core duty in the SISA. To have done so would have paid insufficient regard to the context of regulated superannuation. The extent to which the no-profit rule could have a concurrent application with the SISA is likely to be limited given the breadth of coverage by the Act, including the particular flexibilities available to the SMSF. Those rules are considered in further detail to substantiate this position.

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95 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) 112.

96 *Case V94/447* (1995) 31 ATR 1067, 1075-1076 (AATA) ('Swiss Chalet case'). *Deputy Commissioner of Taxation (Superannuation) v Graham Family Superannuation Pty Ltd* (2014) 99 ATR 544 provides a more recent and similarly extreme instance where this did not occur in an SMSF context.

97 SISA s 17A(1)(f). For further discussion, see: Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [87]-[90].

Sole purpose test

The sole purpose test requires an SMSF trustee to ensure that the SMSF is maintained solely for certain core purposes.[98] Essentially, this ensures that concessionally taxed superannuation savings are used for the purpose of providing retirement or death benefits for, or in relation to, the members.[99] However, that requirement may be satisfied notwithstanding the existence of permitted ancillary purposes, typically relating to the provision of benefits on cessation of a member's employment, other death benefits and approved benefits that are not core benefits.[100] A purpose will go beyond being ancillary where it is simply aimed at providing benefits to members, associates or related parties.

The sole purpose test provides an objective over-arching principle to be applied at all times and to all activities undertaken while the SMSF is in existence. Yet, while a transaction may profit a SMSF trustee and include benefits not specified in s 62 of the SISA, a SMSF may still satisfy the test. In that situation, a conclusion that the SMSF is maintained in accordance with the sole purpose test might be substantiated where:[101]

- The benefit is an inherent or unavoidable part of other activities undertaken by the trustee that are consistent with the provision of benefits specified by s 62(1) of the SISA.

- The benefit is remote or isolated, or is insignificant (whether it is provided once only or considered cumulatively with other like benefits) when assessed relative to other activities undertaken by the trustee that are consistent with the provision of benefits specified by s 62(1) of the SISA.

- The benefit is provided by the SMSF on arm's length commercial terms (for example, if the benefit is provided at market value), consistent with the financial interests of the

98 SISA s 62(1).
99 SISA s 62(1)(a).
100 SISA s 62(1)(b).
101 Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [13]. The Ruling refers to the now repealed SISA s 52 rather than ss 52B and 52C which are now applicable to the SMSF.

SMSF and at no cost or financial detriment to the SMSF.[102]

- All the activities of the SMSF trustee are in accordance with the covenants set out in ss 52B or 52C of the SISA.

- All the SMSF's investments and activities are undertaken as part of or are consistent with a properly considered and formulated investment strategy.

These considerations can be contrasted to the following factors, which support the view that an SMSF is not being maintained in accordance with the sole purpose test:[103]

- The SMSF trustee negotiated for or sought out the benefit, even if the additional benefit is negotiated for or sought out in the course of undertaking other activities that are consistent with s 62 of the SISA.

- The benefit has influenced the decision-making of the trustee to favour one course of action over another.

- The benefit is provided by the SMSF to a member or another party at a cost or financial detriment to the SMSF.

- There is a pattern or preponderance of events that, when viewed in their entirety, amount to a material benefit being provided that is not specified under s 62(1) of the SISA.

These matters, whilst by no means exhaustive, highlight a significantly broader investigation and a degree of flexibility that is lacking in the no-profit rule. The sole purpose test requires a holistic assessment, such that consideration of a benefit in isolation from the overall maintenance of the SMSF would result in a misapplication of the test.[104] In addition, since each SMSF has its own peculiar set of circumstances in relation to its maintenance, the test

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102 The terms 'cost' and 'financial detriment' may include expenses incurred by an SMSF to provide a benefit or income foregone to provide a benefit.

103 Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [12].

104 Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [11].

may yield different results for different SMSFs despite each making similar investments or resulting in a similar quantum of profit to the trustee. On this basis, it is clearly important to assess how a SMSF trustee came to make an investment or undertake an activity, which is likely to vary from trustee to trustee.[105] Once again, that approach is difficult to reconcile with the no-profit rule.

Specific restrictions

In addition to the sole purpose test, the SISA contains a range of specific rules that apply to a SMSF trustee as a further means of constraining particular types of activity. In some instances, these rules embody elements of the no-profit rule; in others they are inconsistent with it. This disparity illustrates the narrow purpose of the specific rules in the SISA to target particular activities identified by the legislature as being inconsistent with the retirement income objective and requiring deterrence. The inconsistency of some activities with this objective is stark, such as transferring private assets to the SMSF in order to obtain cash before meeting a condition of release. However, the specific rules in the SISA also cover more complex arrangements and contain anti-avoidance safeguards to prevent their circumvention through artificial means.

Like the sole purpose test, the specific rules in the SISA have broad application to circumstances where the party benefiting from the transaction is not necessarily the SMSF trustee. They are also connected to the sole purpose test, in that their failure may reflect that the circumstances of the SMSF do not satisfy the sole purpose test. The following examples[106] are illustrative of the specific rules in the SISA applying to an SMSF trustee which, in part, embody elements of the no-profit rule:

- A SMSF trustee is prohibited from lending money, or providing financial assistance using the resources of the SMSF, to a member of the SMSF or a relative of a member of the SMSF.[107]

[105] Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [16].

[106] Adapted from Australian Taxation Office, Self Managed Superannuation Fund Ruling SMFR 2008/2: Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* to the provision of benefits other than retirement, employment termination or death benefits (2008) [97].

[107] SISA s 65.

- Subject to specific exceptions, an SMSF trustee is prohibited from acquiring assets from related parties of the SMSF.[108]

- Subject to specific exceptions, an SMSF trustee cannot recognise or in any way sanction an assignment of a superannuation interest or a charge over or in relation to a member's benefits or an SMSF asset.[109]

- Subject to specific exceptions, an SMSF trustee is prohibited from borrowing or maintaining an existing borrowing of money.[110]

- All SMSF investment dealings must be at arm's length or must be conducted on arm's length terms and conditions.[111]

- Subject to transitional provisions and specific exceptions, an SMSF trustee is prohibited from acquiring or maintaining in-house assets that have a total market value in excess of 5% of the total market value of SMSF assets.[112]

Aside from the broad range of issues that are covered, many of the specific rules in the SISA are subject to exceptions to limit their application to the SMSF. For example, the in-house asset restriction does not extend to business real property (BRP) subject to a lease, or lease arrangement, between an SMSF trustee and a related party of the SMSF.[113] Similarly, the prohibition against acquiring assets from a related party of an SMSF does not apply to prevent the acquisition of a listed security[114] or BRP acquired by an SMSF at market value.[115] Although containing less scope for immediate profit, there is also no restriction to prevent an SMSF from selling its assets to a trustee, provided that the transaction occurs at market value.

The identified exceptions in the SISA provide considerable scope for SMSF trustees to transact and profit from their position. This is particularly the case given that, other than statutorily entitled access to records by the SMSF auditor and ATO, it is likely that the trustee will be the only party aware of the opportunities to profit. Accordingly, beyond the differences with the sole purpose test, the scope for profit by the SMSF trustee through

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108 SISA s 66.
109 SISR regs 13.12, 13.13, 13.14.
110 SISA s 67.
111 SISA s 109.
112 SISA Part 8 Div 3.
113 SISA s 66(5).
114 SISA s 66(2)(a). This exception is not restricted to an SMSF.
115 SISA s 66(2)(b).

specific legislative exceptions demonstrates a further layer of inconsistency with the no-profit rule. This is not necessarily a reason for concern, but illustrates that the SMSF context justifies a broader range of transactions should be permitted that would otherwise be unacceptable where the trustee-member distinction has greater significance.

Finally, it is important to recognise that any profit derived by a trustee will ultimately be derived by the members, albeit in a different capacity, or other such persons as they direct. That outcome is consistent with the substance of the SMSF as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. Given that characterisation, the focus is necessarily concerned less with whether a trustee has profited to the detriment of the beneficiaries, and more with the integrity of the retirement income objective; that is, whether the activities of the SMSF, which are in substance decisions by the members, are consistent with the specific rules contained in the SISA. To the extent that a profit is not sanctioned by those rules, the profit is more accurately one derived by SMSF members to the detriment of the public. Again, that observation is consistent with the public context of the SMSF, where the real point of conflict (including unsanctioned profit making) is between SMSF members as self-interested investors and the public who require assurance that the taxation concessions which support SMSFs are properly used for retirement income purposes.

4.3.5 Consequences for the SMSF

The SMSF exemplifies the case law conclusion that the trustee of a superannuation fund cannot in many instances reasonably be expected to avoid conflict between their duty and interest. The requirement for member representation that is traditionally identified as a potential source of conflict is extended by the SMSF definitional requirement that all members be trustees or trustee-directors. Though this may seem to perpetuate the scope for conflict to arise, what it in fact does is support an even stronger justification of why the no-conflict rule is unsuitable. The example of a single member SMSF reiterates this conclusion by illustrating that any trustee decision is in substance made for his or her own benefit. On that basis, the analysis would fancifully descend into whether individuals can have a conflict with themselves, assuming that members are willing to pursue an action against themselves, albeit in a different capacity.

The unsuitability of the no-conflict rule for single member SMSFs persists for those SMSFs with multiple members. This is because, as noted earlier, irrespective of membership the substance of the SMSF is a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. The decisions made by the SMSF are in substance decisions agreed by the members for their own benefit. Those members are therefore the true source of SMSF decision making and accept responsibility for those decisions. That is why each SMSF trustee will, despite the appearance of unfairness, be equally responsible from a regulatory perspective for any non-compliant activity. The "unfairness to [the trustee] as an individual should not, however, obscure the nature of the fund, the role of trustees or the regulatory system within which they function".[116]

These considerations support the view that conflict in the SMSF context is more accurately a conflict between SMSF members and the public as to whether the actions of an SMSF are consistent with the retirement income objective, as prescribed through the SISA, before accessing publicly funded taxation concessions. Aside from this, the unsuitability of the no-conflict rule is reiterated by the fact that the SISA has, with or without consideration of fiduciary law, legislated an overriding importance that *all* SMSF members must also be trustees or trustee-directors for the SMSF to exist. Accordingly, there is limited scope for the no-conflict rule to operate concurrently with the existence of a statutory requirement that has placed all members in that position.

Similar difficulties arise when assessing the suitability of the no-profit rule for the SMSF. This occurs because any such profit is more accurately one derived by SMSF members, albeit in a different capacity, arising from actions that they have agreed to undertake. On that basis, it becomes incoherent to have members requiring each other to account for profits arising from decisions to which they have previously agreed. Once again, given the substance of the SMSF, the public is the relevant party to whom an account is due for profits made in contravention of the SISA.

In addition, while aspects of the no-profit rule have been incorporated into the SISA, in the SMSF context their inclusion is not for the strict purpose of ensuring that SMSF trustees do not profit from their position to the detriment of the beneficiaries. This is apparent from the fact that, beyond any flexibility within the sole purpose test, there is a range of exceptions to the specific rules contained in the SISA that enable SMSF trustees to profit from their position. Where trustee profits arise from activities that come within these sanctioned parameters, they are consistent with the retirement income objective and should not be obstructed by fiduciary law.

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[116] *Shail Superannuation Fund v FCT* (2011) 86 ATR 339, 349 (AATA).

These considerations support the view that there is minimal function for the no-conflict and no-profit rule in the SMSF context. Accordingly, they do not provide persuasive grounds to retain the trust framework. That conclusion is substantiated by both the purpose of the retirement income objective reflected in the SISA and the underlying substance of the SMSF. That said, care should be taken before concluding that there is no role whatsoever for fiduciary duties. This is due to the fact that, whilst all SMSF trustees have regulatory responsibility for all actions of the SMSF, that does not mean that unauthorised activity could not occur through some unsanctioned unilateral action. Presumably this would be limited to multiple member SMSFs, given the implausibility that individuals could take unauthorised action against themselves. For those types of SMSF it is possible that joint and several liability for regulatory purposes under the SISA for the actions of an SMSF might exist concurrently with a claim by one trustee against another in equity. That conclusion does, however, require acceptance that the SMSF relationship is in fact one to which fiduciary duties apply. Alternatively, the preferred route would be to seek other grounds of recovery that better align to the substance of the SMSF.

Finally, it is important to note that the SISA provides its own mechanism for recovery by a person who suffers loss or damage by another due to a breach of the covenants.[117] The action is for contravention of the statute, not simply for breach of contract (or trust), even though the contravention is for breach of a covenant that is (taken to be) contained in the governing rules of the SMSF. The SISA does not address the issue of an SMSF trustee accounting for a breach of the no-conflict or no-profit rule. However, the fact that a breach of fiduciary duty does not require another party to have suffered loss or damage supports the view that the fiduciary obligation has some limited residual application to the SMSF. To that extent, abandoning the trust would *not* necessarily mean that fiduciary law actions would cease to apply, but would require, beyond presumption, a proper assessment of whether the SMSF relationship is in fact one to which fiduciary duties apply. That is in any event the preferred course of enquiry, and is consistent with the approach identified in *Lock v Westpac Banking Corporation*.[118]

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[117] SISA 55(3) provides that a person who suffers loss or damage as a result of conduct of another person that was engaged in in contravention of a covenant may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention.

[118] (1991) 25 NSWLR 593, 607 (Waddell CJ).

4.4 The SMSF and trust law duties

4.4.1 The interaction of trust law and the SISA

4.4.1.1 Background

The contribution of trust law duties provides a further basis to analyse the suitability of the trust framework for the SMSF. These duties must be considered in light of the more direct statutory intervention through the covenants that are taken to have effect even where the governing rules of the SMSF do not include them.[119] Accordingly, while it is clear that, upon accepting office as a SMSF trustee, such a person will become subject to all of the trust law notions of trustee duties, it is important to appreciate that the scope for application of those duties has been modified.

The extent to which trust law duties contribute and are suitable for the SMSF context is dependent on how those duties interact with the SISA. In that regard, the covenants' existence and narrow application to an SMSF trustee is the result of legislative reform to improve the standards embodied in the (now repealed) original covenants that applied generally to all regulated superannuation fund trustees.[120] For an SMSF trustee those reforms have, with limited exception, simply resulted in the content of the original covenants continuing to apply, albeit re-numbered and relocated to another part of the SISA. It was considered that moving these requirements so that they are separately identifiable would improve the interpretation and readability of the SISA.[121] Unfortunately, given the absence of substantive change, there is limited explanatory discussion of the covenants,[122] let alone elaboration on their interaction with trust law.

Given the consistency in wording between the covenants and the original covenants, case law guidance on the original covenants remains instructive. Similarly, given the explanation during the Second Reading speech of the Superannuation Industry (Supervision) Bill 1993 (Cth) (SISB) that the measures gave effect to the then Treasurer's statement Strengthening

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119 SISA ss 52B(1), 52C(1).

120 The now superseded "original covenants" were contained in SISA s 52(2). SISA s 52 replaced and substituted by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

121 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (Cth) 32.

122 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 (Cth) 32-33.

Super Security[123] (Strengthening Super), it is useful to refer to that document. In particular, its guidance that the purpose of the original covenants "was essentially a clarification of the obligations already imposed by trust law" and that the delineation of those obligations was "intended to set out clearly the responsibilities of responsible entities and assist members in pursing their interests under trust law". These statements support the view that the original covenants were directed at explaining the existing trust law duties in a series of simplistic statements, so as to improve understanding of what was already required by regulated superannuation fund trustees. Adopting a consistent approach that the covenants are explanatory statements of existing trust law duties, trust law would have critical importance in providing the detail of what is being explained through those statements. It also provides grounds to retain the trust framework, given that the SMSF trustee would in substance be regulated by trust law pertaining to the trust, rather than some other legal vehicle.

An alternative explanation is that the covenants go beyond clarification and amount to a codification. To the extent that they do exhaustively prescribe the duties of a SMSF trustee, the retention of the trust as a means of ensuring the continued application of trust law duties is not persuasive. That is, the statutory regime would cover the field and trust law duties would have no separate scope of operation. Support for the codification view appears during the SISB Second Reading debate when, addressing the original covenants, the then Parliamentary Secretary explained "what we have done is simply transcribe trust law – already existing trust law that will govern the behaviour of these people – codify it and write it down".[124] Whilst this explanation is clear, it is difficult to accept that any such intention ultimately transpired into the SISA, given the statutory preservation of the law of a State or Territory (presumably including general trust law) to the extent that such law is capable of operating concurrently with the Act.[125]

Beyond these comments it is also useful to note the different basis on which trust law and the covenants apply. The difference is that trustee duties were developed at general law on the basis of judicial supervision.[126] They were not developed in the context of supervision by a regulatory authority, such as the ATO. Whilst the covenants may have some genesis in trust law, the critical matter is that the regulator must be satisfied they have been contravened before exercising their regulatory powers. It is not a case of postulating whether a court would

123 John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 6.
124 Gary Johns, Parliamentary Secretary to the Treasurer, 'Superannuation Industry (Supervision) Bill 1993' (Second Reading Debate at the House of Representatives, Canberra, 27 September 1993) 1103.
125 SISA s 350.
126 *VBN v APRA* (2006) 92 ALD 259, [327] (AATA).

intervene in its supervisory role to determine that an SMSF trustee has contravened their duties. Were that the case, the scope for intervention would be limited to where the trustee has given reasons for the way that discretion had been exercised, or otherwise to determine whether such discretion has been exercised in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was given.[127] That approach would be inconsistent with the decision by Parliament to require an initial determination to be made as to whether the SMSF trustee has contravened a duty.[128]

Ultimately, support for the preferred non-codification view can be found in *Australian Securities Commission v AS Nominees*,[129] from observations on the original covenants by Finn J that "[t]hese provisions reflect, or are emanations of, established common law rules". Consistently, the Administrative Appeals Tribunal in *VBN v APRA*[130] (*VBN*) and *VCA v APRA*[131] (*VCA*) agreed that the original covenants did not simply restate the general law but were statutory enactments. On that basis, the covenants and trust law duties combine as a hybrid body of rules that together produce the essential constraints on SMSF trustee behaviour. The covenants play the predominant role, given the requirement that any trust law duty must be capable of operating concurrently with the SISA. Proceeding on that basis, the analysis moves to examine the extent to which trust law contributes to this partnership and in doing so address the significance of trust law duties as a basis for determining the suitability of the trust framework.

4.4.1.2 Interpreting the covenants

To assess the significance of trust law to the SMSF it is necessary to examine the content of the covenants and assess the scope for trust law's contribution. Whilst the obligations imposed by the covenants are in some respects wider than those under trust law, the examination also reveals that some of their requirements lack a trust law counterpart. This observation highlights the importance of undertaking a provision-by-provision analysis, so as to avoid inaccurate generalisation. The inability to simply equate the covenants to trust law demonstrates the fact that they support a different context, namely the retirement income objective, which involves the consideration of matters that are not necessarily aligned to those contemplated under trust law.

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127 *VBN v APRA* (2006) 92 ALD 259, [327] (AATA).
128 *VBN v APRA* (2006) 92 ALD 259, [327] (AATA).
129 (1995) 62 FCR 504, 532.
130 (2006) 92 ALD 259, [323].
131 (2008) 105 ALD 236, [250].

When examining the covenants, it is important that the correct approach to their interpretation be applied. Notwithstanding that they are expressed differently to trust law obligations and do not contain complete restatements of the law, the use of similar terms provides some basis to suggest that Parliament intended to enact a parallel obligation. To the extent that they are ineloquent reiterations of trust law, it may seem reasonable to simply interpret their meaning by reference to established trust law duties. That approach would tend to make the covenants consistent with trust law and therefore permit the latter's concurrent operation with the SISA, although presumably with limited scope if the duties are the same. However, it would also fail to address the question of what regard should be given to words employed in the covenants that are inconsistent or absent from any trust law counterpart.

Although it would be convenient, the proper course to interpreting the covenants cannot be to identify how the trust law applied before their enactment (and the original covenants) and then adopt an interpretation consistent with that law. Irrespective of whether the SISA represents a statutory code, a partial restatement of trust law obligations or a new legislative regime, as a matter of interpretation its language should be construed according to its natural meaning and without any presumption that the intention was to merely restate antecedent trust law. Unless the language of the statute itself is doubtful or there is some other special ground, there is little reason to depart from the cardinal rule of statutory interpretation that requires the words of a statute to be read in their context.[132]

This approach has been applied to situations involving the interpretation of a taxation statute that adopted words previously employed by the courts in explaining common law or equitable principles. For example, in *FCT v Stone*, Kirby J emphasised the danger of digressing from the language of the legislation to earlier principles developed in the courts:[133]

> ... the danger of incorporating judicial words when fulfilling the task of giving meaning to legislative command ... is such that remarks can easily be taken out of context. Thus, they may pay insufficient attention to the provisions of the legislation there under consideration. This is a very common problem in statutory interpretation. In effect, it derives from the methodology of the common law and the respect that it conventionally accords to judicial elaboration.
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> In every case where an earlier judicial elaboration is said to be relevant to giving meaning to provisions in legislation, it is essential to compare the statutory language that is under consideration. Otherwise, judicial words, uttered in relation to earlier and different statutory

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132 Refer *K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd* (1985) 157 CLR 309, 315 (Mason J).

133 (2005) 222 CLR 289, 313.

> formulae, will be applied unthinkingly although the foundation of the written law has changed.

These observations translate to the task of interpreting the covenants where many of the terms employed also exist in trust law. The risk of incorrectly equating trust law duties to the covenants is particularly high given the existence of extrinsic material concerning the original covenants suggesting that Parliament at least intended to enact similar obligations. Similarity does not mean that the SISA and trust law obligations equate, and is not a substitute for a proper construction having regard to both the immediate context of the sub-section concerned and the general context of the SISA.

It is also important to note that a proper construction of the covenants does not necessarily mean excluding consideration of materials outside the SISA, since the task of statutory interpretation clearly permits the use of legitimate aids to construction.[134] The *Acts Interpretation Act 1901* (Cth) (AIA) states that in the interpretation of an Act, the preferable approach to construction is one that would promote the purpose or object underlying the Act,[135] and may require reference to extrinsic material, such as to confirm its meaning or to determine meaning in the presence of ambiguity.[136] The relevant materials are those located or referred to in the text of the SISA or that were available to Parliament before it enacted the SISA or that reflect its consideration.[137] In this regard, there is a range of materials that to varying degrees highlights the importance of trust law as the basis for interpreting the original covenants.

4.4.1.3 An interpretative role for trust law

The objective of the SISA is to make provision for the supervision of certain entities engaged in regulated superannuation, including the SMSF. In pursuing this objective, it dissects various positions that would otherwise exist under trust law. The potential for this to occur is apparent from the Second Reading Speech of the SISB in the House of Representatives, when the then Parliamentary Secretary to the Treasurer, Mr Johns, described its objective was to give effect to the new prudential arrangements for superannuation announced by the then Treasurer, Mr Dawkins, on 21 October 1992 Strengthening Super Security. Mr Johns explained that the SISB provided for a "clear delineation of the basic duties and

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[134] *Cooper Brookes (Wollongong) Pty Ltd v FCT* (1981) 147 CLR 297, 320 (Mason and Wilson JJ).
[135] *Acts Interpretation Act 1901* (Cth) s 15AA.
[136] *Acts Interpretation Act 1901* (Cth) s 15AB(1)(a), (b)(i).
[137] *Acts Interpretation Act 1901* (Cth) s 15AB(2).

responsibilities of trustees".[138] That explanation supports an intention behind the original covenants and by inference the covenants, to enact a clear stand-alone set of rules to constrain trustee behaviour. Those rules may or may not be consistent with trust law.

The characterisation of the covenants as a clear stand-alone set of rules that delineate what is required by a trustee for regulatory purposes would resolve many interpretative uncertainties. It would focus the analysis on what was intended by the stand alone set of rules and permit recourse to extrinsic aids, including but not limited to trust law. Unfortunately, the weight attributed to this approach based on the remarks of Mr Johns is not assisted by his earlier comments on trustees regarding the importance of "legislative sanctions for the proper performance of their fiduciary responsibilities".[139] To the extent that the original covenants reflected general law, that law is more accurately trust law and not the law of fiduciaries. It is suggested that the reference to fiduciary responsibilities should be viewed as a generalisation, without regard or knowledge of legal niceties.[140] That would be consistent with the many unfortunate generalisations made whilst formulating and debating the SISB, and illustrates the difficulty of ascertaining exactly what Parliament has intended.

A clearer explanation of the original covenants and their separation from trust law can be drawn from the comments of Mr Rocher, who after announcing coalition support during the course of the SISB Second Reading debate in the House of Representatives, observed:[141]

> The legislation represents a major change to the legal basis for the regulation and prudential supervision of superannuation funds in this country. To date, superannuation funds have relied largely on trust law and common law precedents to guide them in their operations. There have been relatively few statutory requirements, despite the mass of superannuation legislation in recent years which has largely been concerned with defining the tax treatment of superannuation savings.
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> Most of the considerable uncertainty that has plagued superannuation in recent years has emanated from those often changing statutory requirements and taxation measures. The legislation largely overturns the existing legal basis for superannuation fund operations and

138 Gary Johns, Parliamentary Secretary to the Treasurer, 'Superannuation Industry (Supervision) Bill 1993' (Second Reading Speech at the House of Representatives, Canberra, 27 May 1993) 1101.

139 Gary Johns, Parliamentary Secretary to the Treasurer, 'Superannuation Industry (Supervision) Bill 1993' (Second Reading Speech at the House of Representatives, Canberra, 27 May 1993) 1101.

140 For example, it is difficult to see how the best interest duty could at general law be characterised as a fiduciary duty rather than a trust law duty.

141 Allan Rocher, Member for Curtin, 'Superannuation Industry (Supervision) Bill 1993' (Second Reading Debate at the House of Representatives, Canberra, 27 September 1993) 1066-1067.

> replaces it with the type of black letter law that now characterises the new corporation law that has been introduced with mixed success.

Although these comments do not specifically refer to the original covenants, that is implicit from the comparison made to the previous regulatory dependence on trust law. The description of the legislation as a type of black letter law suggests a decoupling from trust law and the commencement of new arrangements to supervise regulated superannuation. They reiterate the danger for interpretative error if the trust law meaning of words contained in the covenants is simply adopted without due regard to context. The context to be drawn from Mr Rocher's observations is an underlying intention to go beyond a restatement of trust law, to change the law and to impose standards that may or may not reflect the existing law.[142]

Adopting a black letter law approach would move interpretation away from a pre-occupation with trust law and the extent to which it has been reproduced, to focus on what has been delineated by black letter law as the SMSF regulatory condition for accessing a concessional taxation environment. The proper interpretation of those requirements may or may not produce uncertainties for which trust or other antecedent laws should be considered. On that basis, whilst trust law may be instructive, its significance as a justification for retaining the SMSF trust framework is diminished.

The ALRC59 is instructive on the interpretation of the original covenants and by inference the covenants. It clarified the relationship of the original covenants to trust law as follows:[143]

> … The Review did not intend to codify or alter the underlying equitable principles. The proposal was limited to the inclusion in legislation of a minimum set of duties that could not be derogated from by the deed or other constituting document. That aspect of the proposal received widespread support ... The favourable reaction to this proposal and the Review's consultations have confirmed its view that the inclusion of a minimum set of duties in legislation will bring the advantages mentioned in DP 50 namely:
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> - it will lead to a better understanding and awareness of responsible entities' legal responsibilities and those of members of boards of responsible entities
> - it will enable uniform modification of common law trust principles which are not appropriate for superannuation schemes
> - it will enhance the ability of the regulator to enforce the fiduciary obligations of responsible entities when necessary

142 *VBN v APRA* (2006) 92 ALD 259, [309] (AATA).
143 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.16] (footnotes omitted)

- it will eliminate the possibility that obligations considered essential for responsible entities of superannuation schemes could be eroded by the terms of the trust deed or other constituting document.

Once again, these observations are consistent with a black letter law approach; the second bullet point, in particular, highlights that trust law principles may be inappropriate for regulated superannuation. They propose a set of legislative duties that might complement or modify the trust law as necessary to accommodate the unique characteristics of a superannuation scheme. However, whilst the views of the ALRC59 appear to be well considered, it must be accepted that they are limited to recommendations and necessarily pre-date the statements in Strengthening Super Security, which characterised the original covenants as "essentially a clarification of the obligations already imposed by trust law".[144] That explanation would seem to reiterate the ongoing importance of trust law, assuming the intention was simply to clarify existing trust law obligations.

However, it is also important that the elaboration in Strengthening Super Security is not misinterpreted. The use of the word "essentially" in the preceding passage suggests that the explanation was intended to be no more than a generalisation, omitting the detail that this would be achieved through a new set of rules that would depart from trust law where necessary to accommodate the context of regulated superannuation. That would be consistent with the black letter law approach adopted elsewhere in Strengthening Super Security, such as when explaining that the enhanced prudential arrangements would be achieved, in part, "through clearly defining the basic duties and responsibilities of trustees".[145] Similarly, in addressing the deficiencies of trust law, the Strengthening Super Security refers to the "essential trustee duties, which represent fundamental obligations to beneficiaries and which will not be able to be excluded or modified by governing documents (generally trust deeds)".[146]

Accepting that there is support for a range of views, ultimately the conclusion drawn is that, although the covenants do not amount to a codification of trust law, they also cannot be accurately characterised as simply a clarification of that law. This approach is supported by the observations of the Tribunal in *VBN* when addressing the original covenants:[147]

[144] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 6.
[145] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 1-2.
[146] John Dawkins, Treasurer, 'Strengthening Super Security, New Prudential Arrangements for Superannuation' (1992) 6.
[147] *VBN v APRA* (2006) 92 ALD 259, [328].

> ... we consider that Parliament intended to base the covenants in the SIS Act on those under the general law but to extend their ambit and to do so in an entirely new context. It is a context that is intended to ensure that the covenants are met and not merely that the trustee is able to establish that it exercised its discretion in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was given.

Consistent with these views, the covenants are accurately characterised as a new set of legislative black letter law requirements for SMSF trustees. Though they may have had some genesis in trust law, beyond any residual concurrent application, the contribution of trust law is limited to an interpretative role. The extent to which trust law does contribute to the interpretation of the covenants will provide evidence to either support or further erode the suitability of the trust framework for the SMSF context.

In considering the contribution of trust law, the foregoing analysis is limited to addressing those covenants that have common application to the SMSF and have an identifiable trust law counterpart.[148] Beyond the structural separation of the covenants from those pertaining to other types of regulated superannuation, they also differentiate between SMSFs with corporate or non-corporate trustees.[149] While there are not significant differences in approach between the two configurations, the analysis is limited to the non-corporate trustee structure. That approach is adopted on the basis that it reflects the simplest application of the trust framework and for practical purposes is consistent with how the majority of SMSFs are structured. Although the alternative corporate trustee structure may have advantages, those considerations are not overwhelmingly significant in terms of assessing the suitability of the trust framework for the SMSF. Corporate trustee or otherwise, the framework still adopts a trust structure.

4.4.2 Duties concerning conduct

Three covenants contained in s 52B(2) of the SISA can be conveniently grouped under the heading of conduct. These duties direct a trustee in their administration of the SMSF as follows:[150]

(a) to act honestly in all matters concerning the fund;

[148] Accordingly, the covenants in s 52B(2)(g), (h) concerning access to information and reserves have been omitted from any detailed consideration.
[149] SISA s 52B, 52C.
[150] SISA s 52B(2).

(b) to exercise, in relation to all matters affecting the fund, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;

(c) to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries.

4.4.2.1 Covenant one – s 52B(2)(a): Honestly

The first covenant requires SMSF trustees to act honestly in all matters concerning the fund and has little evident foundation in trust law. The replacement of the word "entity" with "fund" is the only variation from the original covenant.[151] The dictionary definition of the word "honestly" is to act in a truthful, fair or honourable way.[152] It is used to emphasise the sincerity of an opinion, belief or feeling.[153] In the absence of ambiguity, it would therefore seem that the requirement to act honestly imposes a duty on trustees to act truthfully in all matters concerning the SMSF. Consistent with the use of the word honestly to emphasise the sincerity of an opinion, belief or feeling, its inclusion in the covenant could prima facie import a subjective standard. However, given the intention behind the covenants to delineate the basic duties for *all* SMSF trustees, there are conceivably grounds to adopt an objective approach.

Whether a subjective or objective approach is justified may, however, prove of little consequence. After all, in trust law liability for breach of trust is not premised upon the trustee's state of mind, whether viewed subjectively or objectively, but rests on strict liability, namely from the fact of the breach itself.[154] As a result, from a trust law perspective the "honesty" covenant adds little to an SMSF trustee's existing duties. It is, to this end, difficult to identify what independent duty is created by the need for honesty that does not subsist through later covenants or general law.

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[151] SISA s 52(2)(a), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

[152] Judy Pearsall (ed), *The New Oxford Dictionary of English* (Clarendon Press, 1998) 879.

[153] Judy Pearsall (ed), *The New Oxford Dictionary of English* (Clarendon Press, 1998) 879.

[154] In the instances where trust law itself investigates questions of "honesty", the inquiry involves primarily either attempts to exempt trustee liability via provision in the trust deed (which courts have held cannot succeed to exclude dishonesty: see, for example, *Armitage v Nurse* [1998] Ch 241) or to extend liability to a non-trustee who has been involved in a trustee's breach of trust (where aspects of dishonesty justify the extension of liability: see, for example, *Farah Constructions Pty Ltd v Say Dee Pty Ltd* (2007) 230 CLR 89).

At most, it appears, the words adopted in the covenant to "act honestly" may be comforting for many SMSF trustees as a non-legal concept that they understand and support as a shared community value. The covenant may, in this regard, engender a quality or educational value that may have some practical influence on behaviour. This lesser role could provide a familiar signpost for all participants in a landscape where SMSF trustees are likely to have divergent legal and commercial abilities.

4.4.2.2 Covenant two – s 52B(2)(b): Ordinary prudent person

The second covenant is somewhat more complex than the first, although as a statutory enactment its interpretation should be approached in a similar manner. In particular, the covenant requires a SMSF trustee to exercise, in relation to all matters affecting the fund, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.[155] The replacement of the word "entity" with "fund" is the only variation from the original covenant.[156]

All matters affecting the fund

The first point to observe is that the covenant prescribes a standard of behaviour in relation to "all matters affecting the fund". This gives it a very broad application and is appropriate due to the unique context of the SMSF. That is, beyond taking the form of a trust, the SMSF (and regulated superannuation generally) attracts significant individual and public support as a means to achieve the Government's retirement income objective of improving retirement incomes. Given the importance of this objective to both the individual participants and the broader public, it follows that, to be most effective, the covenant should be expressed in a way that prevents elusive and disguised types of conduct from escaping the prescribed standard.

Although the emphasis in later parts of the covenant appears to concern property, the breadth of the phrase "all matters affecting the fund" extends its application beyond matters directly relating to trust property to those affecting its administration and management or the entity itself.[157] Accordingly, the scope of the covenant would cover an extensive range of matters, such as investment and preservation of assets, and extend to the way in which the SMSF

[155] SISA s 52B(2)(b).
[156] SISA s 52(2)(b), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
[157] *VCA v APRA* (2008) 105 ALD 236, [346] (AATA).

trustee administers and manages the entity itself.[158] This broad interpretation follows logically from the unambiguous words “all matters affecting the fund”. In the absence of ambiguity, it does not seem necessary to draw upon trust law to obtain further clarification.

However, in the improbable event that some uncertainty did arise with the expression “all matters affecting the fund”, recourse to trust law is not necessarily helpful, since the comparable duty of a trustee is expressed as applying in “managing the trust affairs”.[159] Those words clearly differ from those employed in the covenant and produce uncertainty whether the range of matters having an impression on the management of a trust’s affairs would include all of the matters addressed by the covenant. While the covenant may have been based upon the trust law phrase, its scope has arguably been extended beyond the trust law duty so as to better accommodate the context of regulated superannuation. At a minimum it serves to highlight the need for caution before adopting the scope of a differently worded trust law duty.

Ultimately, reference to general trust law guidance is unlikely to be unnecessary due to the existence of specific regulated superannuation case law considering the phrase “all matters affecting the entity” in the original covenant. By providing that the duty extends to all matters affecting the entity, the Tribunal in *VBN* concluded that the original covenant must be incorporating a reference to the management of its business, and so to the management of the trust affairs as part of its business, as well as those matters that affect it as the entity and so as a corporate body.[160] The same conclusion is applicable to the current covenant, given that it has, apart from replacing the word “entity” with “fund”, persisted with the same expression.

Care, skill and diligence

The second important aspect of the covenant is its focus on the SMSF trustee exercising “care, skill and diligence” in all matters affecting the fund. Once again, the meaning of those words does not raise any significant ambiguity so as to justify recourse to trust law, other than when addressing the standard to which care, skill and diligence must be exercised. That matter is, in any case, clarified by subsequent words stating that the required standard is that of an “ordinary prudent person”.

[158] *VCA v APRA* (2008) 105 ALD 236, [346] (AATA).
[159] *VBN v APRA* (2006) 92 ALD 259, [325] (AATA).
[160] *VBN v APRA* (2006) 92 ALD 259, [325].

Ordinary prudent person

The adoption of the standard "ordinary prudent person" imports an objective test on the standard of care that is required by SMSF trustees in all matters concerning the fund. Accordingly, such a trustee is not assessed on the basis of his or her own skill or particular expertise but on the standard expected of an "ordinary prudent person". The meaning of that phrase can be addressed by separately examining the meaning of the expression "ordinary person" and the word "prudent".

Dealing with the easier task, it is evident that the word "prudent" has been employed to raise the required standard beyond that expected of an ordinary person. The ordinary meanings of the word "prudent" include being "careful to follow the most politic and profitable course" and "[w]ise, discerning, sapient".[161] These meanings are clear and do not in themselves raise particular uncertainty requiring guidance from trust law. In the context of the covenant, the word "prudent" prescribes the characteristics that the identified ordinary person should exhibit. That is, an ordinary person who is careful, astute and exercises sound judgment in dealing with property, which is not his or her own but belongs to another and which the person feels morally bound to preserve.[162]

The expression "ordinary person" presents a more challenging interpretative task. While it may seem easy to identify the characteristics of an ordinary person by way of a generalised statement, a precise explanation might be expected to vary according to social, cultural and economic factors. Nonetheless, even in a highly pluralistic society, it should be possible to identify some common purposes, expectations and values that could be attributed to an "ordinary person". The difficulty of this task, and the desire to ensure that an objective standard of care, skill and diligence is applied consistently, has inevitably meant that cases have sought further guidance on this phrase, typically by reference to trust law.

However, the unsuitability of trust law to guide the interpretation of the covenant is once again evident from the different words employed in its standard of an "ordinary prudent person experienced in business".[163] The trust law standard cannot simply be adopted without regard to the fact that the covenant does not contain the words "experienced in business". The omission of those words tends to suggest that SMSF trustees are subject to a lower standard than prescribed under trust law, so that recourse to that law may not always produce a correct

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[161] James Murray (ed), *The Oxford English Dictionary* (Clarendon Press, 1933) vol 8, 1533-1534.
[162] *VCA v APRA* (2008) 105 ALD 236, [347] (AATA).
[163] Noel Davis, *The Law of Superannuation in Australia* (LexisNexis, 2009) Service 18, 81,211.

outcome. That approach is supported in logic that the standard expected of a prudent person of business would reasonably be expected to be a higher standard than the standard expected of an ordinary prudent person who is inexperienced in business.[164]

Unfortunately, regulated superannuation case law has been unwilling to accept such a clear distinction when comparing the original covenant and trust law. Whilst not addressing whether the trust law standard was higher than the original covenant, the New South Wales Court of Appeal in *Manglicmot v Commonwealth Bank Officers Superannuation Corp Pty Ltd*[165] (*Manglicmot*) stated that "[t]he terms of the covenant appear to have been taken from *Re Whiteley* (1886) 33 Ch D 347." That comment is useful to demonstrate that trust law does have a degree of consistency with the original covenant, though the inclusion of the word "appear" also reflects a degree of indecision as to the extent of that consistency. Overlooking this difficulty, an examination of *Re Whiteley*[166] (*Whiteley*) reveals an exposition by Lindley J in terms almost identical to those contained in the original covenant when explaining the additional requirement for trustees to exercise caution when making investment decisions. In particular, Lindley J observed that:[167]

> [t]he duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider: the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.

Accepting that *Whiteley* did provide the basis for the standard in the original covenant, it follows that the duty of a trustee is a "one that requires a standard of care, skill and diligence that is in excess of that normally imposed on a trustee".[168] As the covenant has adopted the same expression contained in the original covenant, that standard should also arguably apply to the SMSF trustee. Yet that approach would produce a significantly different outcome from the earlier conclusion on the required standard made without reference to trust law. Assuming that the standard in *Whiteley* is adopted, it remains difficult to understand why a higher standard reserved under trust law for investment decisions would be an appropriate standard to be applied broadly in relation to "all matters affecting the fund".

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164 For support for this view refer Noel Davis, *The Law of Superannuation in Australia* (LexisNexis, 2009) Service 18, 81,211.

165 (2011) 282 ALR 167, [120].

166 (1886) 33 Ch D 347.

167 (1886) 33 Ch D 347, 355.

168 *Preuss v APRA* (2005) 60 ATR 1137, [74] (AATA).

Further guidance on these uncertainties can be found in *Fouche v Superannuation Fund Board* (*Fouche*), in which Dixon, McTiernan and Fullagar JJ addressed the meaning of the phrase "ordinary prudent person experienced in business" as follows:[169]

> ... we are of the opinion that it does not differ materially from the duty which rests on trustees in relation to investments. The duty is not so onerous as it once was. In modern times it is regarded as defined by *Speight v Gaunt* and *In re Whiteley; Whiteley v Learoyd*. It is a duty of reasonable care - the care which an ordinary prudent man of business would take ...

These comments suggest that the standard of an "ordinary prudent person experienced in business" can be equated to the duty resting on a trustee in relation to investments. Furthermore, the standard is captured by the duty of reasonable care, the care that an ordinary prudent man of business would take. Whilst this guidance is helpful, the case did not involve or require any particular consideration of the SMSF context. It seems odd that the covenant should place a man of business standard upon SMSF trustees, who are not otherwise required to have any particular business acumen. The strangeness of that outcome, combined with the fact that the covenants have narrow application to the SMSF and the absence of SMSF specific case law guidance, provides reason to question whether trust law guidance is suitable. Yet given the case law views on the original covenant, that approach would require willingness by a court to give significant weight to the SMSF context.

Finally, though not given significant weight in the case law, there are two further explanations for the omission of the words "experienced in business" from the original covenant that may be instructive. Both explanations provide broad support to distinguish the trust law duty from the covenant. First, it is said that the omission of the words "experienced in business" responded to submissions on the SISB that their inclusion would mean people not experienced in business should not be a trustee.[170] Such an outcome would have been contrary to the Government's policy objective of equal member and employer representation for employer-sponsored regulated superannuation funds. That rationale is also applicable to the substance of the SMSF as a mechanism for self-directed member investment and the absence of Government policy to exclude investors that are inexperienced in business.

Secondly, it is reasoned that, at time of drafting the SISB, it was thought that there were in fact two duties: the duty to act as an ordinary prudent person would in dealing with property

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[169] (1952) 88 CLR 609, 641 (footnotes omitted).

[170] Donald Duval, 'The Objectives of the Superannuation Supervisory Legislation' (Paper presented at the Superannuation 1994 National Conference for Lawyers, Gold Coast, 24-26 February 1994) 1.8.

of another, and the duty to act as a prudent person experienced in business would in dealing with their own property.[171] Ultimately, Parliament determined that the SISA should only deal with the first duty and left the second to general law. On that basis, irrespective of whether the trust law is capable of dissection into two separate duties, the intention was that only the first identified part of trust law should be reflected in the original covenant. While the trust law standard of a prudent person experienced in business could potentially have concurrent application, context provides reason to suggest that is not so. To accept otherwise would be inconsistent with the absence of any Government policy requiring SMSF members to have any particular business acumen and the substance of the SMSF as a mechanism for self-directed member investment.

The SMSF context – conclusions

It is difficult to avoid the conclusion that the covenant has a basis in trust law. That said, its application entails a new context and arguably applies with broader ambit to cover all matters affecting the fund. For that purpose, it requires a SMSF trustee to exercise "care, skill and diligence". Importantly, the degree of care, skill and diligence must be that which an "ordinary prudent person" would have exercised in dealing with the property of another for whom the person felt morally bound to provide.[172] That standard is self-contained in the covenant, albeit one that is difficult to identify. A convenient approach to overcome this difficulty would be to accept guidance from trust law. However, the suitability of trust law for that purpose requires an assessment of whether that approach is necessarily consistent with the proper application of trust law to the SMSF.

The difficulty with the standard in the original covenant was to a large extent responsible for the recommendation of the Cooper Report to clarify and raise the standard required. That recommendation was adopted for *non-SMSF* regulated superannuation funds, so that the standard of care, skill and diligence was raised to that of a "prudent superannuation trustee".[173] Although the SMSF was not subjected to the new standard and received limited discussion in the Explanatory Memorandum[174] accompanying this change, the fact that the reforms were targeted to particular types of regulated superannuation fund is encouraging and consistent with the importance of context permeating in this chapter. Furthermore, at a

[171] Donald Duval, 'The Objectives of the Superannuation Supervisory Legislation' (Paper presented at the Superannuation 1994 National Conference for Lawyers, Gold Coast, 24-26 February 1994) 1.9.
[172] *VCA v APRA* (2008) 105 ALD 236, [341] (AATA).
[173] SISA s 52(2)(b).
[174] Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (Cth) 32-33.

detailed level the standards expected of non-SMSF trustees now also vary depending on the nature of the regulated superannuation fund. For example, additional duties apply to trustees of MySuper products in recognition of that fact that default members typically delegate all aspects of their superannuation to a trustee.[175] However, enhanced trustee obligations are not applied to products where members play a more active role, for example, a registrable superannuation entity (RSE), such as a corporate, industry or public offer fund.[176]

The willingness to move beyond generic duties for all regulated superannuation fund trustees and acknowledge the substance of different products demonstrates the emergence of a differentiated approach and acceptance of the important role of context. In the case of the SMSF the absence of any particular need to create additional trustee obligations to resolve conflict and give priority to beneficiaries explains why the content of that covenant did not need to be changed from the original covenant, despite the requirement for SMSFs to adopt the trust framework. Acknowledging the substance of the SMSF provides a basis to suggest that the standard in the covenant may not necessarily be consistent with or suitably guided by antecedent trust law.

Whilst Parliament has chosen to adopt words in the covenant that have been used in trust law, it is clear that they fall short of reflecting an intention to fully restate that law. At best the covenant might be described as a partial restatement. Yet it remains difficult to understand how a partial restatement could clarify a broader set of pre-existing trust law obligations, when it eschews a particularly high degree of precision. Perhaps more persuasively, it seems entirely illogical to apply a trust law standard requiring consideration of a prudent man of business when as a matter of practical hard fact SMSF trustees are not otherwise required to, and may not, have any particular business acumen.

The large number of SMSFs in existence and continued absence of any business or educational skills as a barrier to entry suggests that a potentially widespread inability to satisfy a prudent man of business standard is not detrimental. That is entirely consistent with the true characterisation of the SMSF adopted in this chapter, as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. Since the ability of SMSF participants to successfully invest is not dependent on any particular business skills or knowledge, it is inappropriate to apply a trust law standard that does not align with the substance of the vehicle.

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175 Refer enhanced obligations imposed under SISA s 29VN.
176 Refer SISA ss 52, 52A.

An alternative approach to the covenant that better aligns with the SMSF context is to apply the ordinary meaning of the words chosen. That approach was adopted by the Tribunal in *VCA*, in its consideration of the original covenant, to conclude that a person must exercise, in relation to all matters affecting the entity, care, skill and diligence of the sort that an ordinary person who is careful, astute and exercises sound judgment would show in dealing with property, which is not his or her own but which belongs to another and which the person feels morally bound to preserve.[177] Although that explanation may be difficult to accept for non-SMSF regulated superannuation given the comments in *Fouche*,[178] the separation of the covenants and the unique SMSF context enables that decision to be distinguished and the approach in *VCA* to be adopted. On that basis, the suitability of trust law guidance continues to be eroded.

4.4.2.3 Covenant three – s 52B(2)(c): Best interests of the beneficiaries

The third covenant requires a SMSF trustee to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries.[179] That requirement differs slightly from the original covenant, which required a trustee to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries.[180] Like the second covenant, the third covenant has a degree of complexity that cannot be resolved solely by reference to the ordinary meaning of the words used. This is particularly due to the uncertainty created from the adoption of the words "best interests". The scope for trust law to guide interpretation of that phrase is unsurprising, given the trust law obligation to act in the best interests of beneficiaries.

Once again, the suitability of trust law to guide interpretation of the covenant is supported by comments made during the House of Representatives Second Reading debate of the SISB that the original covenants were aimed at clarifying existing obligations, "to make nice and clear the way in which we expect these people to act".[181] The analysis of the preceding covenants, though, justifies caution before adopting that rationale and equating the covenant with the trust law best interests obligation of a trustee. The need for caution is also consistent with

177 *VCA v APRA* (2008) 105 ALD 236, [347].
178 (1952) 88 CLR 609, 641, wherein the High Court held that the original covenant required a standard of care that an ordinary prudent man of business would take.
179 SISA s 52B(2)(c).
180 SISA s 52(2)(c), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
181 Gary Johns, Parliamentary Secretary to the Treasurer, 'Superannuation Industry (Supervision) Bill 1993' (Second Reading Debate at the House of Representatives, Canberra, 27 September 1993) 1103.

superannuation related case law, such as *Invensys v Austrac Investments Ltd*[182] (*Invensys*) where Byrne J observed insofar as the original covenant has attempted to capture the trust law, it is not altogether clear what has been codified and whether the drafter of the code accurately stated the existing law.

The principal difference between the covenant and the original covenant has been the removal of the phrase “ensure that”. Although the Explanatory Memorandum supporting the change provides little insight, it appears largely due to significant uncertainty surrounding the expression’s purpose and effect. That uncertainty arose from the fact that the ordinary meaning of the word “ensure” means “[t]o guarantee (a thing) to a person”.[183] That would suggest that the original covenant did not simply require a trustee to operate in a particular way but specified a further degree of dedication, requiring some type of surety or guarantee that they will do as required. Yet given that it is the trustee of a regulated superannuation fund who is responsible for decisions and to whom the original covenants were addressed, it seems superfluous to have some type of double obligation over the same restriction. On that basis, the observation was made in *Invensys* that “[i]t is difficult to see how these words add anything to a covenant by a trustee simply to perform and exercise its duties and powers in the best interests of the beneficiaries”.[184] And, more strongly, it was concluded in *Manglicmot* that “[t]he words “to ensure” add nothing; an obligation is an obligation”.[185]

One explanation of the words “ensure that” was raised by the trial judge in *Manglicmot v Commonwealth Bank Officers Superannuation Corporation*, that “since the trustees are empowered to delegate, the legislature wanted to make it clear that the trustees could not avoid responsibility for a failure by the delegate to exercise powers in the interests of members by saying that the task was delegated”.[186] That approach was not raised as a conclusion but as one possibility that would at least give the words some role to play. A general meaning was offered in *Invensys* that “[p]erhaps the best that can be made of these apparently superfluous words ‘to ensure that’ ... is that Parliament intended to emphasise the seriousness of this covenant and the requirement that it be strictly observed”.[187] In both instances, the reluctance to reach any definitive conclusion highlighted the need for legislative reform that has now been addressed by the removal of the words.

[182] (2006) 198 FLR 302, [102] (Byrne J).
[183] James Murray (ed), *The Oxford English Dictionary* (Clarendon Press, 1933) vol 3, 205.
[184] (2006) 198 FLR 302, [103] (Byrne J).
[185] (2011) 282 ALR 167, [121] (Giles JA, Young and Whealy JJA agreeing).
[186] (2010) 239 FLR 159, [51] (Rein J).
[187] (2006) 198 FLR 302, [103] (Byrne J).

"Best interests" of the beneficiaries

The principal aspect of the covenant inviting guidance from trust law arises in relation to the phrase "best interests". Taken literally, that phrase creates the impression that some absolute or superlative is in contemplation.[188] Certainly that would be consistent with the ordinary meaning of the word "best", which conveys a standard "[o]f the highest excellence, excelling all others in quality".[189] However, given the interpretative difficulties with the preceding covenants, the meaning of the expression "best interests" should be derived having regard to the context in which it is used.[190]

Whilst the SMSF has a particular context, the adoption of the phrase "best interests" is by no means unique, with widespread use in many areas of the law. Two commonly cited applications are trustees' obligation to act in the best interests of the beneficiaries and company directors' duty to act in the best interests of the company. But given the focus on the suitability of trust law to guide interpretation of the covenants, the trust law meaning of the expression is considered in further detail. The examination must once again go beyond identifying that the covenant has adopted words used to describe a trustee's obligation under trust law and conclude that the same obligation is reflected in the covenant. There are also a number of preliminary matters that cannot be ignored before examining the content and suitability of the trust law meaning of the phrase "best interests".

The first point to observe is that, as well as similarities, there are differences between the expression of the trust law obligation and the covenant. For example, whilst the trust law requires a trustee to act in the best interests of beneficiaries "as a whole", that requirement is absent in the covenant. Accordingly, the covenant might be construed broadly to require a trustee to act in the best interests of each beneficiary or a group of beneficiaries. If correct, that approach would not easily reconcile to the position under trust law. It is also possible that, just as the words "ensure that" were unnecessary, the words "as a whole" may also be superfluous. That approach would be consistent with the conclusion in *Manglicmot* that the original covenant did not materially add to a trustee's obligations under trust law.[191]

The second point arises from the typically adopted explanation of the trust law obligation by reference to the decision in *Cowan v Scargill*[192] (*Cowan*). In particular, it is important to

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188 *Charlton v Baber* (2003) 47 ACSR 31, [46] (Barrett J).
189 James Murray (ed), *The Oxford English Dictionary* (Clarendon Press, 1933) vol 1, 823.
190 *Charlton v Baber* (2003) 47 ACSR 31, [46] (Barrett J).
191 (2011) 282 ALR 167, [121] (Giles JA, Young and Whealy JJA agreeing).
192 [1985] Ch 270.

appreciate that the explanation in *Cowan* was made in the context of the trustee's duty to invest. Accordingly, a narrow interpretation of that case may support a conclusion that the obligation only applies to trustee investment.[193] In contrast, the covenant does not specifically limit itself to investment. Its words signify a broader application to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries. That said, the context of the SMSF is one whose primary concern is investment and therefore the difference may not be particularly significant. In any event, the trust law duty is commonly described as "paramount", which supports a characterisation that it is a foundational duty upon which everything else is built.[194] Applying that approach, the trust law obligation should also logically extend beyond investment to all administrative and managerial duties and powers of trustees that affect beneficiaries as a whole.[195]

The third point is that the suitability of the trust law best interests obligation to guide interpretation of the covenant cannot be determined without a detailed examination of that obligation. As reiterated throughout this chapter, generalisations should be avoided because in trust law context is critical. Ultimately, the best interests obligation will arise and its content determined when the trustee carries out some other duty, by reference to the trustee's scope of authority and the context of the trust in question. Accordingly, even within the class of regulated superannuation those variables will change between SMSF and non-SMSF types of trust, since there are differences in how the SISA operates to limit and expand the way that a trustee might advance the best interests of the beneficiaries. This explanation of the best interests obligation as a fluid concept adapting to context is consistent with the comments of Gummow J in *Breen v Williams*[196] suggesting the requirement does not exist as a separately identifiable duty at general law.

<u>Process and outcome</u>

Given these preliminary observations, it seems that rather than clarifying the requirements of the covenant, trust law contributes significant complexity. To determine whether trust law can provide suitable guidance it is necessary to determine the content of the trust law best

193 Geraint Thomas, 'The duty of trustees to act in the 'best interests' of their beneficiaries' (2008) 2 *Journal of Equity* 177, 185.
194 Geraint Thomas, 'The duty of trustees to act in the 'best interests' of their beneficiaries' (2008) 2 *Journal of Equity* 177, 185.
195 Geraint Thomas, 'The duty of trustees to act in the 'best interests' of their beneficiaries' (2008) 2 *Journal of Equity* 177, 185.
196 (1996) 186 CLR 71, 137-8.

interests obligation as it applies to the SMSF. To commence this task, a common starting point is adopted in the following statement by Megarry V-C in *Cowan*:[197]

> The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of trustees towards their beneficiaries is paramount.

In starting at this point it is not contended that the best interests obligation originated solely from these remarks. Although variously expressed, the principle seems to have been applied without contention in earlier case law.[198] Putting the origins of the obligation aside, the statement is useful because Megarry V-C made his comments in a superannuation context while addressing the trustee's duty to invest. Upon initial analysis of the statement, the adoption of the expression "in the best interests" suggests the existence of alternatives and that the focus of the enquiry is concerned with outcome. In measuring these outcomes, the inclination would be to assume that the words "best interests" mean best financial interests.

However, the true meaning of the best interests obligation requires further analysis beyond focusing on the best financial outcome. The obligation does not exist in isolation and must have regard to the other duties of the trustee, which will necessarily vary according to the context. Support for this approach is evident by Megarry V-C's reference in *Cowan*[199] to the ordinary prudent man standard of care enunciated by Lindley LJ in *Whiteley*.[200] Thus, the task of a trustee cannot simply be to pursue the very best financial return by taking the highest risk investment. In the SMSF context, the unacceptability of that approach is reinforced in the SISA through the covenants imposing investment restrictions and the need for an investment strategy. These requirements combine to prevent a literal interpretation of the words "best interests" to pursue an extreme risk and return strategy. In any event, the historical practice of SMSF investment portfolios being overweight in conservative type investments tends to suggest that participants do not typically seek to maximise financial returns through excessive risk.

Further insight into what is actually required by the best interests obligation emerges when Megarry V-C's initial statement is read in light of his further explanation, that it was insufficient for trustees to avoid causing harm to the beneficiaries:[201]

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197 [1985] Ch 270, 286-287.
198 For example, *Re Charteris* [1917] 2 Ch 379, 393-394 (Swiften Eady LJ), 397 (Bankes LJ).
199 [1985] Ch 270, 289.
200 (1886) 33 Ch D 347, 355.
201 [1985] Ch 270, 295.

> Trustees must do the best they can for the benefit of their beneficiaries, and not merely avoid harming them ... It is the duty of trustees, in the interests of their beneficiaries, to take advantage of the full range of investments authorised by the terms of the trust, instead of resolving to narrow that range.

These comments suggest that the focus is on process and that the trustees must make an effort to "do the best they can". Adopting that approach, the required standard would be expected to vary depending on the qualities of the trustee concerned. The fact that the second statement adopted the words "benefit" rather than "best interests" also suggests that they are different expressions of the same standard. In the context of non-SMSF regulated superannuation a focus on process may not be controversial, since in a competitive market it may be reasonable to expect professional trustees have a high and broadly uniform level of skill. The best interests formulation in *Cowan* is more easily applied when the trustees concerned have a degree of expertise to enable both process and outcome elements to be adequately addressed.

The focus on process is more significant for the SMSF, given the absence of any requirement for business, commercial or legal training of trustees. The potentially low skill level of SMSF trustees may raise the prospect that often the best outcome for beneficiaries is not achieved, notwithstanding that the best efforts have been employed taking into account the relevant trustee's degree of ability. One obvious example of this is the statistical fact that SMSFs tend to invest in a narrow range of asset classes, despite that approach being inconsistent with accepted modern investment theory that return is maximised through portfolio diversification.[202] However, this may be entirely acceptable because, in the absence of investment knowledge, the best that a SMSF trustee can do may be to invest all assets in a conservative asset class, such as a term deposit.

It seems, therefore that given the SMSF context and broad ranging ability of participants, significantly greater weight should be given to process than outcome. That position can be contrasted to a more traditional investment trust, where beneficiaries may be more focussed on financial outcomes and seek explanation of trustee investment decisions that yield sub-optimal financial results. Perhaps more fundamentally, when a SMSF is viewed as a mechanism for self-directed member investment, it is difficult to understand how as a matter of principle a decision made by members for their own benefit would not be in their best (financial) interests. Any subsequent concern with the performance of investments is more

[202] Refer Peter Phillips, Alex Cathcart and John Teale, 'The Diversification and Performance of Self-Managed Superannuation Funds' (2007) 40(4) *The Australian Economic Review* 339.

accurately one of personal disappointment, since the beneficiaries have in substance made the relevant decision in their best interests.

Undivided loyalty

Although the conclusions drawn from the statements of Megarry V-C are instructive, it is clear that they do not exhaustively clarify the obligation to act in the best interests of beneficiaries, nor are they easily applied in the SMSF context. Rather than a criticism, this simply reflects the fact that *Cowan* provides a starting point in addressing the best interests obligation. In this regard, it is noted that Megarry V-C himself has commented extrajudically that his judgment displayed "no bold novelty" of approach and was surprised at the view that he had intended to create a new duty.[203] Those comments tend to suggest that the obligation may be explained by or exist as a function of another general law duty pertaining to the trust.

One explanation of the best interests obligation is that it is an expression of the duty of undivided loyalty. Again extrajudically, Megarry V-C gives support for this approach when, in addressing the duty of trustees to exercise their powers in the best interests of the beneficiaries, he stated "[t]he convenient phrase is the trustees' 'duty of undivided loyalty to the beneficiaries' ".[204] The inclusion of the word "convenient" is perhaps unfortunate in that it is unclear whether the explanation was made by way of generalisation or whether the best interests obligation can in fact be equated to the duty of undivided loyalty. Irrespective of what was intended, it seems that there must be a considerable overlap between the duties in order to justify making the statement.

Pursuing this approach, the duty of undivided loyalty lends itself to a more succinct explanation. In the course of Megarry V-C's judgment in *Cowan*[205] reference was made to *Blankenship v Boyle*,[206] during which Gesell J referred with approval to the explanation in *Scott on Trusts*, that "[i]t is the duty of the trustee to administer the trust solely in the interest of the beneficiaries".[207] Accordingly, unless authorised, a trustee is prohibited from placing themselves in a position where their personal interest conflicts (or may conflict) with the interests of the beneficiaries, nor make a profit from the trust property or the office of trustee.

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[203] Robert Megarry, 'Investing in pension funds: The Mineworkers' case' in Timothy Youdan (ed), *Equity Fiduciaries and Trusts* (Carswell, 1989) 159.
[204] Robert Megarry, 'Investing in pension funds: The Mineworkers' case' in Timothy Youdan (ed), *Equity Fiduciaries and Trusts* (Carswell, 1989) 153.
[205] [1985] Ch 270, 292.
[206] 329 F Supp 1089, 1095.
[207] Austin Scott, William Fratcher, *The Law of Trusts* (Aspen Publishers Inc, 4th ed, 1987) Vol IIA, §170.

The duty of undivided loyalty is a proscriptive fiduciary obligation to put the interests of the beneficiaries above all other interests. On that basis, if the duty of undivided loyalty gives a suitable meaning to the covenant, it would be based on the law of fiduciaries, rather than trust law.

However, as a matter of principle there are a number of difficulties in equating the best interests obligation with the duty of undivided loyalty. A significant difficulty is that it is possible to satisfy the duty of undivided loyalty to the beneficiaries of a trust but still fail to act in their best interests.[208] Further scope for inconsistency arises in that the effect of the duty of undivided loyalty may prohibit a trustee from acting in the beneficiary's best interest. The case of *Boardman v Phipps*[209] provides an example. The adoption of the duty of loyalty as the singular basis upon which to explain the best interests obligation and guide interpretation of the covenant would only seem to create further uncertainty.

Beyond these difficulties, there are further anomalies when attempting to apply the duty of undivided loyalty to the SMSF context. In particular, when a SMSF is viewed as a mechanism for self-directed member investment, it is difficult to understand how a decision made by a member for their own benefit would not be loyal to their own best interests.[210] That concern is essentially the same difficulty with the earlier formulation of the obligation and suggests that the duty of undivided loyalty does not provide a satisfactory answer. If the duty of undivided loyalty does have application, it would require a form over substance approach to be employed. That would be inconsistent with the approach of this chapter to present the SMSF context by reference to the true substance of the arrangement.

<u>Particular guidance</u>

Having canvassed the difficulties with trust law reiterations of the best interests obligation and its application to the SMSF, it is understandable that many SMSF trustees may find the covenant completely unworkable. Having regard to the wording employed, it seems accurate to describe its requirements as a hybrid, showing both similarities and differences to "best

208 Geraint Thomas, 'The duty of trustees to act in the 'best interests' of their beneficiaries' (2008) 2 *Journal of Equity* 177, 194.

209 [1967] 2 AC 46.

210 An issue could theoretically arise from an SMSF member having present and future loyalties to themselves. However, the deferred nature of superannuation benefits under the SISA suggests little benefit from such a distinction. For example, a member's loyalty to themselves would not justify a decision to extract preserved amounts for present-day consumption in direct contravention of the SISA requirement that superannuation benefits are quarantined until retirement or meeting a condition of release.

interests” obligation of a trustee under trust law. That characterisation makes it difficult to determine the extent to which trust law is consistent and suitable to guide interpretation of the covenant. Perhaps some comfort can be gained from the case law conclusion on the original covenant that it did not in fact impose any higher standard on a trustee than that arising under general law.[211] However, the suitability of trust law guidance is also questionable given its inability to provide a succinct and universally accepted definition of the best interests obligation. In this regard, the covenant has managed to incorporate uncertainty rather than provide clarification for SMSF trustees.

Judges have been forced to address this uncertainty when interpreting the original covenant and in doing so provide some guidance for the covenant. In particular, Byrne J in *Invensys* observed that the covenant:[212]

> ... appears to be an amalgam of two distinct obligations said to be imposed by law upon trustees of a superannuation fund. The first, which is sometimes referred to as the duty of loyalty or the duty of fidelity to the trust, is that to act in the interests of the beneficiaries; that their interests are paramount and must certainly be placed ahead of the Trustee’s own interests. Nor may the trustee have regard to considerations which are extraneous to the trust. The second is to pursue to the utmost with appropriate diligence and prudence the interests of the beneficiaries.

This explanation provides support for the view that trust law does provide a suitable source of guidance when interpreting the original covenant. However, the fact that the analysis is prefaced by the word “appears” highlights a need for caution, which is prudent given the difficulties surrounding the best interests obligation identified earlier. A further concern is that the second part of the statement appears to overlap with what is specifically provided for in the immediately preceding original covenant.[213] Later in his judgment in *Invensys* Bryne J hesitates once again, when concluding that “[i]t is not altogether clear whether paragraph (c) is intended as a codification … As will appear, it is not necessary that I unravel this”.[214]

Whether as a result of these concerns or upon some other basis, the approach of Bryne J was not applied to the original covenant in a subsequent Tribunal decision in *VCA*, instead preferring to adopt its earlier reasoning in *VCN*. Both decisions can be viewed as interpreting

211 *Manglicmot v Commonwealth Bank Officers Superannuation Corp Pty Ltd* (2011) 282 ALR 167, [121] (Giles JA, Young and Whealy JJA agreeing).
212 (2006) 198 FLR 302, [107] (footnotes omitted).
213 Scott Donald, *What Contribution Does Trust Law Make to the Regulatory Scheme Shaping Superannuation in Australia?* (Australian Prudential Regulation Authority, 2011) 18.
214 (2006) 198 FLR 302, [107].

the original covenant in what is considered to be its administrative context.[215] Particular weight was given to the comments of Barrett J in *Charlton v Baber*[216] (*Charlton*), who reviewed the wide use of expression "best interests" in the family law, trust law, company law and cases concerned with unconscionable conduct and undue influence. Based on these authorities Barrett J concluded:[217]

> "Best interests" is thus an expression concerned with a person's separate and independent welfare. Where the concern to which the "best interests" assessment is relevant centres upon possibilities of undue influence and, perhaps, improper purpose, the task is to consider what the putative victim would have done in seeking to protect his or her own position and promote his or her own advantages with such a degree of selfishness as the circumstances will admit.

In applying the approach in *Charlton* to the regulated superannuation context, the Tribunal in *VCN*[218] and *VCA*[219] decided that "these principles seem to us to be equally applicable to the interpretation and application of the covenant in s 52(2)(c) of the SIS Act". However, yet again the inclusion of the word "seem" would tend to indicate that in both instances the Tribunal's explanation was made with some degree of hesitation. Consistent with the decision of Byrne J in *Invensys* the Tribunal's approach has also attracted criticism[220] and leaves a degree of uncertainty for any application to the covenant.

Without attempting to reconcile the different approaches to the phrase "best interests" that could be applied to the covenant, it is clear that those words have and continue to be used in many areas of the law. On that basis, the words should not be abandoned for the SMSF on the grounds of obscurity. Neither should it be surprising that the expression is incapable of singular definition that is acceptable to its broad range of applications, including those within trust law. Rather than attempting to procure a single meaning and apply that to the covenant, the better approach is to accept its true character as an umbrella-type expression that is capable of adapting to a range of situations. Whilst guidance can be obtained from the use of the words in other areas of the law, the precise scope and meaning of the expression should be determined by the context in which it is used.

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215 Scott Donald, *What Contribution Does Trust Law Make to the Regulatory Scheme Shaping Superannuation in Australia?* (Australian Prudential Regulation Authority, 2011) 18.

216 *Charlton v Baber* (2003) 47 ACSR 31.

217 *Charlton v Baber* (2003) 47 ACSR 31, [52].

218 (2006) 92 ALD 259, [359].

219 (2008) 105 ALD 236, [350].

220 Ellen Liondis, 'Errors, breaches and covenants – common threads from the s 52(2) cases: Part 2', (2007) 18(7) *Superannuation Law Bulletin* 93; Zein El Hassan and Phillip Turner, 'APRA and the AXA Staff Plan Directors' (2006) 18(4) & (5) *Superannuation Law Bulletin* 46; Scott Donald, *What Contribution Does Trust Law Make to the Regulatory Scheme Shaping Superannuation in Australia?* (Australian Prudential Regulation Authority, 2011) 18.

The SMSF context – conclusions

The preceding analysis has not only demonstrated the challenge in providing a succinct and acceptable explanation of the trust law meaning of the expression “best interests” but has questioned whether trust law guidance on that phrase is suitable for the SMSF context. The principal difficulty when applying trust law to the SMSF context is that it gives undue weight to the form of the SMSF as a trust. That approach then leads to a confused analysis as to whether the actions undertaken by a person as trustee are acceptable when viewed from the perspective of their impact on the same person as a member.

These observations highlight the fact that whilst trust law guidance on the best interests obligation is relevant to consider given the SMSF trust structure, that does not mean that it is suitable when the substance of the SMSF is accepted as a mechanism for self-directed investment. Adopting that characterisation of the SMSF shows the obscurity that trust law principles that guide the relationship between a trustee and beneficiaries should be forced upon an individual’s own investment decisions. It illustrates the danger of simply adopting antecedent law to guide interpretation of the covenant without regard to context and prompts a consideration of the suitability of an administrative approach to the covenant as adopted in *VCA* and *VCN*. In both instances the Tribunal addressed the expression “best interests” by considering what a person would do to protect their own position and promote their own advantages with such degree of selfishness as the circumstances admit. That enquiry is more suitable for the SMSF context because it is directly aligned to the substance of how the SMSF is conducted.

Ascertaining the best interests of SMSF members is not a matter that requires an artificial focus on the relationship between trustees and members, but the relationship between members themselves who must collectively agree on the actions of the SMSF. In the case of a single member SMSF, self-directed investment can be made with complete self-interest. For other SMSFs, the mechanism for self-directed investment requires the members to decide on what actions the SMSF will undertake. That will involve members pursuing their own interests to the extent that they can, knowing that agreement must also be obtained from the other members, whose interests and welfare must also be taken into consideration, if the proposed action of the SMSF is to be endorsed. A common example of this member-to-member negotiation is an SMSF having both pension and accumulation members, whereby both classes would need to accept that their best interests are likely require a compromise between growth and capital preservation objectives.

4.4.3 Duties concerning management

A further two covenants contained in s 52B(2) of the SISA can be grouped under the heading of "management". These duties direct a trustee in their administration of the SMSF as follows:[221]

> (d) to keep the money and other assets of the fund separate from any money and assets, respectively:
>
> (i) that are held by the trustee personally; or
>
> (ii) that are money or assets, as the case may be, of a standard employer-sponsor, or an associate of a standard employer-sponsor, of the fund;
>
> (e) not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers.

4.4.3.1 Covenant four – s 52B(2)(d): separation of assets

The requirements of the fourth covenant are clearly expressed and, in comparison to the preceding complexities, do not raise significant uncertainty. That is, a trustee must keep the assets held by the trustee personally and those of the employer-sponsor separate from the assets of the SMSF. In the absence of ambiguity, there is little reason to seek guidance from trust law. The replacement of the word "entity" with "fund" is the only variation from the original covenant.[222]

The first part of the covenant focusses on ensuring a clear demarcation between the money and assets of a SMSF and those of the trustee held personally. Given the adoption of the trust framework, it is understandably difficult not to correlate this requirement to the trust law duty not to mix trust moneys with the trustee's own moneys. Yet once again, while trust law may be a relevant consideration, it does not necessarily follow that such guidance is necessarily suitable for the SMSF.

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[221] SISA s 52B(2)(d), (e).

[222] SISA s 52(2)(d), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

A more accurate rationale for separation of SMSF assets from the personal assets of a trustee (or those of an employer-sponsor) is a legislative mechanism to ensure that regulated superannuation savings are properly used for retirement income purposes. That explanation aligns with the public context of the SMSF discussed in this chapter and the limited concern for the safety of SMSF member interests in comparison to other forms of regulated superannuation, whose context may more readily align with the core incidents of trusteeship under trust law. Although the retirement income objective may in some instances be achieved by a SMSF trustee's adherence with the duty not to mix trust moneys, the narrower scope and different purpose of the trust law duty may not assure this. In order to avoid this misalignment, it is better to accept the covenant as a self-contained and unambiguous standard to maintain the integrity of the retirement income objective.

Further insight on the covenant can be drawn from earlier consideration of the principles surrounding the need to separate fund and trustee assets by the ALRC59. The requirement was explained on the basis that the "responsible entity, by the very nature of being in a position of trust, does not hold the assets of the scheme in its own right".[223] That approach supports the original covenant being based on the trust law duty, reiterating that trustees hold superannuation fund assets not for their own use or benefit, but for the benefit of members of the scheme. Yet in the SMSF context there is reason to question whether that approach can be suitably applied. That is because, in substance, it is the members who determine how the SMSF is conducted and how its assets are applied. The imperative to protect the interests of members from a trustee improperly drawing upon trust assets is significantly less than is the case for other forms of regulated superannuation. In the SMSF context, asset separation is more accurately required to prevent members applying SMSF assets for their own non-prescribed purposes, or alternatively mingling personal assets with those of the SMSF so as maximise taxation benefits.

Beyond these initial comments, the ALRC59 appears to have had difficulty with trust law's suitability when it went on to address the duty to keep money separate from the employer-sponsor's assets that was subsequently included in the original covenant. Rather than explaining this requirement by reference to or extension of trust law, it made the following comment:[224]

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[223] Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.18].

[224] Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.24] (footnotes omitted); OSSA s 3(1) (definition of "superannuation fund").

> The Review accepts that, as a consequence of the requirement in the definition of a superannuation fund in OSSA that such a fund be established for the 'sole purpose' of providing superannuation benefits, the assets of single employer sponsored superannuation schemes are likely to be kept in a separate account apart from the employer's assets.

The foregoing reveals a recognition by the ALRC59 that some duties of a responsible entity are more accurately explained by reference to the sole purpose test, rather than trying to draw upon trust law. Given the continuing importance of the sole purpose test in the SISA and the substance of the SMSF supporting an integrity basis for separating their assets from the trustee's personal assets, there is reason to apply the second part of the ALRC59 explanation to the entire covenant. That is, instead of trust law, the retirement income objective provides the underlying and most suitable explanation. That objective will not be achieved if SMSF assets are not specifically identifiable and quarantined from other non-regulated superannuation purposes.

The SMSF context – conclusions

The separation of SMSF money and assets from those of its trustee (or employer-sponsor) that are held for other purposes is an essential requirement to maintain integrity in the current retirement income arrangements. For regulated superannuation generally, separation of money and assets is supported by public context to assure a broad membership that their superannuation interests are safe. That explanation can be correlated to some extent with the trust law duty not to mix trust moneys. However, when the focus narrows to the SMSF the public context supports separation of money and assets to give the Government and public assurance that the taxation concessions to which SMSFs can access are properly used for retirement income purposes, rather than funding unrelated current day benefits for trustees and others. Although the covenant may have been based on the trust law duty not to mix trust moneys, that law can only provide a limited explanation in comparison to the retirement income objective.

The sole purpose test reflects the retirement income objective and reiterates why assets of a SMSF should be kept separate from the personal assets of a trustee. Although the sole purpose test is in some respects aligned to the beneficiary protection motives behind the duty not to mix trust moneys, it also reflects the need to protect the Government and public interest in regulated superannuation. That is, the SMSF as a mechanism for self-directed member investment encouraged through taxation concessions must be limited to ensure that those concessions are only applied to assets identified as belonging to regulated superannuation and employed for the prescribed sole purpose of providing superannuation benefits for members.[225] That rationale can also be applied to the separation of money and assets of an employer-sponsor of the SMSF. In that regard, it is easy to see that the use of SMSF assets or money by an employer-sponsor would provide a concessionally taxed source of funding for current day business activities rather than being applied for the sole purpose of providing superannuation benefits for members.

Further recent support for accepting the substance of the SMSF and unsuitability of trust law to guide interpretation of the covenant can be found in amendments to insert Regulation 4.09A into the SISR.[226] The regulation requires the trustee of a SMSF to keep money and other assets of the fund separate from any money or assets held by the trustee personally or by a standard employer-sponsor or an associate of a standard employer-sponsor of the fund.[227] As the regulation is a prescribed operating standard, a person who intentionally or recklessly contravenes the standard is guilty of an offence that may result in a fine and/or administrative penalties.[228] In contrast, the unsuitability of the covenant in s 52B(2)(d) of the SISA is reflected in the fact that the ATO was unable to enforce compliance, not being a party affected by and involved in the contravention.[229] In addition, the SMSF members who together participated in a breach were unlikely to take action.

The Explanatory Statement accompanying these changes noted that the Cooper Report had identified that breaches of the existing covenant occur with some frequency.[230] It provided examples, such as "where a SMSF operates using a member's personal bank account rather than through a separate account established for the SMSF, or where assets are recorded in one or more member's name personally, rather than in their capacity as trustee of the SMSF".[231] In both cases, the regulatory concern is explained by going directly to the substance of the SMSF rather than its form as a trust. The concern is one of integrity over the assets and money of the SMSF due to the actions of its members, such as using *their* personal bank account or putting assets in *their* own name. Those actions are inconsistent with the retirement income objective, because they may improperly provide members with funds for

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225 Consistently, the threat of an SMSF losing its tax concessional treatment would be more influential on trustee behaviour than enforcement of trust law obligations owed to beneficiaries.

226 SISR reg 4.09A, inserted by *Superannuation Industry (Supervision) Amendment Regulation 2012 (No 2)* (Cth).

227 SISR reg 4.09A(2)(a), (b).

228 Refer SISA s 34, 166.

229 Explanatory Statement, Superannuation Industry (Supervision) Amendment Regulation 2012 183/2012 (Cth) Attachment 2.

230 Explanatory Statement, Superannuation Industry (Supervision) Amendment Regulation 2012 183/2012 (Cth) Attachment 2.

231 Explanatory Statement, Superannuation Industry (Supervision) Amendment Regulation 2012 183/2012 (Cth) Attachment 2.

current day activities or result in excessive claims that earnings on member assets belong to the SMSF and should be concessionally taxed. It is inept to explain the breach by reference to the trustee-beneficiary distinction or seek guidance from trust law because, once the substance of the SMSF is accepted as a mechanism for self-directed investment, it is simply the actions of the members that need to be constrained.

4.4.3.2 Covenant five – s 52B(2)(e): Not to prevent or hinder functions and powers

The fifth covenant requires a SMSF trustee not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers.[232] Its requirements can be subdivided into two parts and do not vary from those of the original covenant.[233] First, the expression "any contract, or do anything else" ensures that the initial scope of trustee action addressed is very broad. Secondly, this scope is then narrowed by the requirement that the action "would prevent or hinder the trustee in, properly performing or exercising the trustee's functions and powers". Accordingly, the scope of the covenant is critically dependent on the standard reflected in the word "properly" since its positioning in the covenant must be read as qualifying the performance of the trustee's functions and the exercise of its powers.[234]

In considering what amounts to a SMSF trustee "properly" performing or exercising their powers or functions, it would be convenient to drawn upon trust law, specifically the duty on a trustee not to fetter their powers or discretions. That duty requires that, subject to the trust deed, a trustee must not permit other parties to exercise control over the manner in which their discretion is exercised.[235] It ensures that the exercise of trustee discretion is not determined by considerations other than their conscientious judgement at the relevant time, regarding what is in the beneficiaries' best interests.[236] Again, though, the adoption of trust law guidance should not be accepted without detailed consideration of the words in the covenant and regard paid to the SMSF context in which it is applied.

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232 SISA s 52B(2)(e).

233 SISA s 52(2)(e), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

234 *VCA v APRA* (2008) 105 ALD 236, [351] (AATA).

235 *Re Brockbank* [1948] 1 Ch 206; *Walker v Willis* [1969] VR 778, 782 (Lush J); *Quinton v Proctor* [1998] 4 VR 469, 471 (Kellam J).

236 *Re Re King* (1902) 29 VLR 793, 796 (Holroyd J); *Re Stephensons's Settled Estates* (1906) 6 SR (NSW) 420, 424-425 (Street J); *Watson's Bay and South Shore Ferry Co Ltd v Whitfeld* (1919) 27 CLR 268, 277 (Isaacs J).

Commencing with its ordinary meaning, the word “properly” can be defined as “strictly, accurately”, “[f]ittingly, suitably, appropriately” and “[t]horoughly, completely”.[237] Though not unhelpful, these meanings do raise a further degree of uncertainty. There is less scope for misunderstanding the high standards required by the words “strictly, accurately” or “thoroughly, completely”, but that is not necessarily the case with the words “fittingly, suitably, appropriately”. Those words tend to suggest that the standard embodied in the word “properly” does not require some exacting and uniform conformity across all trustees but requires comparison to what is reasonably expected in the circumstances. What is appropriate and suitable for the SMSF context may or may not equate to the standard expected of other regulated superannuation fund trustees.

Whilst this partially clarifies matters, it remains uncertain exactly what standard is the “proper” standard to be applied for the SMSF. In that regard, broad case law guidance can be obtained from the expression “proper, genuine and realistic consideration”, which was considered in *Minister for Immigration and Multicultural Affairs v Anthonypillai*:[238]

> To say that consideration is or is not “proper” necessarily assumes some pre-existing standard of propriety against which the consideration under review can be measured. But what is the content of such a standard? It must be something other than the procedures prescribed by the Act or regulations.

Adopting that approach, the inclusion of the word “properly” in the covenant incorporates an unspecified standard of propriety. That was similarly the view adopted on the original covenant in *VCA*, where the Tribunal, in reference to the word “properly”, said that “[i]t must be a standard that has regard to matters other than breach of the other covenants in s 52 or the other provisions of the SIS Act. Breach of them already exposes the trustee and its responsible officers to sanctions”.[239] Thus, it is necessary to identify what, in the SMSF context, is an appropriate benchmark for the standard. Importantly, in *VCA* it was concluded that the search for the standard in the word ‘properly’ could not simply be resolved by reference to trust law, but the underlying objective to provide for members in retirement:[240]

> ... we must have regard to the role of a trustee charged with responsibility for other persons’ assets intended to secure their future when they cease to be part of the Australian workforce. We should also have regard to the fact that the role discourages the entrepreneurial spirit

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[237] James Murray (ed), *The Oxford English Dictionary* (Clarendon Press, 1933) vol 8, 1470-1471.
[238] (2001) 106 FCR 426, 441 (FC).
[239] (2008) 105 ALD 236, [353].
[240] (2008) 105 ALD 236, [355] (AATA) (footnotes omitted).

> referred to by Clarke and Sheller JJA in *Daniels v Anderson* and encourages a conservative approach.

By drawing upon the responsibility of a trustee for other persons' assets intended to secure their future on leaving work, the statement indicates that the standard operates for a particular purpose. However, the explanation is only partially transferable to the SMSF. The substance of the SMSF cannot be accurately explained using a traditional trust law characterisation of a trustee charged with responsibility for other persons' assets. Although that may be appropriate for some other forms of regulated superannuation, it is inconsistent with the substance of the SMSF as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions.

The SMSF is conducted by and at the risk of the members concerned, and they are responsible for determining how assets are applied. In substance there are no "other person's assets" for which responsibility is charged upon a trustee, but responsibility on member investors to act properly. Furthermore, while SMSF assets are clearly intended to secure the future of its members when they cease to be part of the workforce, in doing so they may be applied in ways that might be improper for other types of regulated superannuation. For example, an SMSF's sole asset might acceptably comprise the BRP subject to a lease, or lease arrangement, between a SMSF trustee and a related party of the SMSF.[241]

The statement also indicates that regard should be given to the general law principle that encourages trustees to adopt a conservative approach. Given the requirement that a regulated superannuation fund must adopt a trust structure, it is understandable that trust law guidance was sought. Yet, the Tribunal in *VCA* expressed doubt about the extent to which the conservative approach embodied in trust law could remain suitable. In particular, the following statement recognises that regulated superannuation has evolved from its conservative trust law origins:[242]

> For all that it is a conservative approach, it contains an interesting tension for a modern superannuation trustee is not expected merely to preserve the funds but there is pressure to earn a return that is healthy but not one achieved with unacceptable risk to the funds.

The tension for regulated superannuation trustees is consistent with the analysis in this chapter describing superannuation as a financial product, which to be competitive must meet

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[241] Refer exception contained in SISA s 71(g).
[242] (2008) 105 ALD 236, [355].

member expectations of financial return and typically offer a range of member investment choice. Thus, it would seem that the standard expected of trustees lies in some middle ground between conservatism and entrepreneurialism. That would be consistent with APRA's reluctance to accept that a regulated superannuation fund trustee acts in the best interests of members if narrow or risky choices are made available without regard to the amount or proportion of the member's interest that may be placed in the particular strategy.[243] Accordingly, a degree of conservatism referable to trust law principles continues to limit excessive risk taking behaviour.

But it is difficult to adopt even this limited connection between regulated superannuation and trust law vis-a-vis the specific SMSF context. The SMSF as a mechanism for self-directed member investment reiterates its purpose to enable members to manage their own retirement income arrangements. The fact that SMSF members are willing to take control over investment decision making, devise their own investment strategy and agree to forgo access to prudential compensation arrangements shows greater consistency with entrepreneurial spirit than conservatism. Indeed, the flexibility of member decision-making and ability to undertake transactions that would be unacceptable for other regulated superannuation funds is one of SMSFs' significant attractions. Thus, it is reasonable that the range of conduct that is considered proper should be broader than is permissible for other types of regulated superannuation fund, though ultimately directed towards the same retirement income objective. Beyond the duties and responsibilities in the SISA or SISR, the content of the standard must reflect the purpose of regulated superannuation to improve retirement incomes, as explained in the Government's retirement income policy. It is unnecessary to seek guidance from trust law on that standard.

The SMSF context – conclusions

The covenant prohibits SMSF trustees from undertaking any action that would prevent them from properly performing or exercising their functions and powers. The uncertainty from this requirement arises from the inclusion of the work "proper" as the basis for the standard. To some extent, guidance can be obtained from case law on the same requirement in the original covenant, which indicates an unwillingness to relinquish guidance from trust law on this matter. Yet case law also reveals uncertainty over the extent to which trust law principles remain suitable due to tensions in reconciling a conservative approach to the expectations of the modern day regulated superannuation fund.

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243 Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [45].

In the SMSF context, the suitability of trust law guidance is further diminished. As a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions, the focus is squarely upon the members of the SMSF. Although the trust form has been adopted, in substance there are no "other person's assets" for which responsibility is charged upon a trustee. In substance the responsibility lies with the members as self-directed investors to act properly. On that basis it is difficult to accept that the standard in the word "properly" could simply be resolved by reference to trust law.

Even beyond the difficulty of adopting guidance incompatible with the substance of the SMSF, trust law guidance is also unsuitable given that it is aligned to principles of conservatism. While it may be difficult to accept that an SMSF could be properly conducted with excessive and narrow risk choices, the very nature of the SMSF aligns to members having a significant degree of entrepreneurial spirit. That is encouraged by the SISA legislative framework that enables the SMSF to undertake a range of actions that are likely to be improper for other regulated superannuation funds. Perhaps the most entrepreneurial of these is the capacity of a SMSF to conduct a business and undertake related party transactions.[244]

4.4.4 Duties concerning investment

Further covenants contained in s 52B(2) of the SISA can be grouped under the heading of investment.[245] However, as the analysis is limited to those covenants that have a clear corresponding trust law duty, the covenant addressing reserves is not analysed.[246] The covenant concerning access is also omitted,[247] given the SMSF context is one where members participate in fund decision making and therefore obligations surrounding access are likely to have little practical application. The remaining duty to direct the trustee in their administration of the SMSF is follows:[248]

> (f) to formulate, review regularly and give effect to an investment strategy that has regard to the whole of the circumstances of the fund including, but not limited to, the following:

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244 Refer Australian Taxation Office, *Carrying on business in an SMSF* (23 September 2016) <https://www.ato.gov.au/Super/Self-managed-super-funds/Investing/Carrying-on-a-business-in-an-SMSF/>.
245 SISA s 52B(2)(f)-(h).
246 SISA s 52B(2)(g).
247 SISA s 52B(2)(h).
248 SISA s 52B(2)(f).

(i) the risk involved in making, holding and realising, and the likely return from, the fund's investments, having regard to its objectives and its expected cash flow requirements;

(ii) the composition of the fund's investments as a whole including the extent to which the investments are diverse or involve the fund in being exposed to risks from inadequate diversification;

(iii) the liquidity of the fund's investments, having regard to its expected cash flow requirements;

(iv) the ability of the fund to discharge its existing and prospective liabilities.

4.4.4.1 Covenant six – s 52B(2)(f): Investment strategy

The sixth covenant requires a SMSF trustee to formulate, review regularly and give effect to an investment strategy.[249] It provides a SMSF trustee with a set of criteria to which the investment strategy must have regard. The criteria are reflective of modern investment theory, namely: risk, return, diversification, liquidity and liabilities. The covenant is flexible in that it includes, but does not limit itself to, these considerations and is therefore capable of accommodating changes to investment theory and practice. This flexibility is enhanced by the fact that the covenant does not prescribe what weight should be given to each particular criterion. The replacement of the word "entity" with "fund" and insertion of the requirement to "review regularly" is the only variation from the original covenant.[250]

The first difficulty with the covenant is that the phrase "investment strategy" is not defined in the SISA. The omission of that detail leaves some uncertainty for SMSF trustees as to what qualifies as an acceptable investment strategy in terms of the level of detail required. Some guidance on formulation could be obtained from *Superannuation Circular No.II.D.1 Managing Investments and Investment Choice*[251] (SC II.D.1), to the extent that industry practice is persuasive. However, in the SMSF context the fact that investment is member-directed may reduce the level of detail necessary to explain a strategy adopted. In comparison to APRA-regulated superannuation funds, SMSFs may also prefer to avoid more complex

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249 SISA s 52B(2)(f).

250 SISA s 52(2)(f), repealed by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

251 Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) 6-13.

investments that require significant explanation.[252] That said, there must be some level of detail necessary to give an investment strategy a proper function. An absence of any detail beyond "to invest" would be difficult to reconcile with the preceding discussion that an SMSF trustee exercise, in relation to all matters affecting the fund, the same degree of care, skill and diligence as an ordinary prudent person.[253]

A second difficulty concerns exactly how an SMSF trustee should have regard to the factors specified in the covenant in order to produce a suitable investment strategy. That is somewhat distinguishable from the earlier covenants considered in this chapter, whereby the uncertainties followed from an adoption of words used to express a corresponding trust or other general law obligation of trustees. That said, in the absence of any particular guidance in the SISA on how each criterion should be weighted, trust law may provide guidance to an SMSF, given a trustee's duty to invest under trust law.

In the absence of exceptional circumstances, trustees are required at general law to invest so as to yield the best return for the beneficiaries, judged in relation to the risks of the investment in question.[254] Trustee investment is also constrained by a number of additional duties. Trustees are required to apply care and exercise the skill of a prudent person in the exercise of their investment power. They are also required to preserve trust capital, exercise caution and to avoid speculation. Where the deed gives the trustee a broad discretion to invest, the performance of the duty still remains subject to the ordinary prudent person standard of care[255] and the fiduciary duties to avoid conflict and unauthorised profit.[256] To some extent, these trust law duties have been considered during the discussion of earlier covenants before concluding that their scope for application in the SMSF context is limited. On that basis, caution should once again be exercised before equating the covenant with the trust law duty to invest without further detailed consideration.

Consistent with the original covenant, the substance of the covenant aligns with the recommendation contained in ALRC59 to incorporate a duty for trustees to take a portfolio approach to investment.[257] In making that recommendation it was observed that the principal

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252 Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper* 7 (unpaged).
253 SISA s 52B(2)(b).
254 *Cowan v Scargill* [1985] Ch 270, 287 (Megarry VC).
255 *Crook v Smart* (1872) 11 SCR (NSW) Eq 121; *Sidey v Huntly* (1900) 21 LR (NSW) Eq 104, 108 (Simpson CJ); *Pacella v Sherborne (No 2)* [2010] WASC 186, [57] (Blaxell J).
256 *Antill v Mostyn* [2010] NSWSC 587, [17]-[19] (Bryson AJ).
257 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.30].

function of a superannuation fund is the investment of contributions to provide retirement income and that other types of trust may or may not share such a long term objective.[258] That observation is important. The acknowledgment that different trusts have different objectives and functions that will affect the trustee's duty to invest endorses the importance of context identified in this chapter.

In considering the trust law duty to invest in the superannuation context, the ALRC59[259] identifies with the approach taken at first instance in *Nestle v National Westminster Bank Plc*[260] (*Nestle*). In *Nestle* Hoffmann J observed that there was no dispute with the general principles to be applied by reference to the classic statement of trustee investment duty by Lindley LJ in *Whiteley*.[261] However, his Lordship considered this standard to be extremely flexible, being:[262]

> capable of adaption to current economic conditions and contemporary understanding of markets and investments ... Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.

The consistency of that explanation with the approach in the original covenant (and continuation in the covenant) would suggest that Parliament endorsed the ALRC59 recommendation, which in turn reflects the proposition under trust law that trustees to take a portfolio approach to managing investments. In this regard, Modern Portfolio Theory (MPT) is typically adopted as an accepted investment theory, focussing on whole of portfolio risk diversification. However, that does not necessarily mean that the covenant simply reflects trust law, with diversification of risk being the standard of an ordinary prudent trustee. The decision in *Nestle* was upheld on appeal,[263] rejecting the argument that the trustees should have adopted a diversified approach to investment during a particular period. However, that outcome did not reflect a rejection of MPT, but the inability of the plaintiff to demonstrate "that failure to diversify in that decade was a course which no prudent trustee would have followed".[264]

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258 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.30].
259 Australian Law Reform Commission Companies and Securities Advisory Committee, *Collective Investments: Superannuation*, Report No 59 (1992) [9.30].
260 [2000] WTLR 795.
261 (1886) Ch D 347, 355.
262 [2000] WTLR 795, 797.
263 [1993] 1 WLR 1260.
264 [1993] 1 WLR 1260, 1281 (Staughton LJ).

A further difficulty in aligning the covenant to the MPT approach under trust law is that MPT is applied in a range of investment contexts and is not exclusive to trustee investment. Given the unsuitability of the trust framework for the substance of the SMSF, it is dangerous to discount guidance provided by non-trust related applications of MPT. Furthermore, given the broad unsuitability of the trust framework for the SMSF, it is questionable whether MPT, guided by trust law or otherwise, should even be considered. In this regard, the words used in the covenant (risk, return, diversification, liquidity and liabilities) are not unique to MPT and have been commonly adopted in earlier investment theory.[265] While trust law and portfolio theory appears to have influenced the ALRC59 recommendations and original covenant, in common with State based trustee legislation the most that can be accurately concluded is that the covenant "effectively requires (or at least strongly encourages) trustees to adopt modern portfolio theory".[266] A conclusion more aligned to the substance of the SMSF is that the covenant accommodates contemporary investment theory, but leaves it open to the court to determine what theory is appropriate to the particular circumstances under consideration.[267]

The SMSF context – conclusions

It is apparent that the recommendation of the ALRC59 that the duty to invest be included as a core legislative duty was influenced by trust-related case law, and specifically that trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory. To this end, current portfolio theory accepts MPT as a valid investment theory to be adopted by trustees. However, whilst that may provide a sound basis for trustee behaviour, it is difficult to accept that the covenant equates with trust law, including that MPT should be adopted by SMSF trustees.

The eroded suitability of trust law to guide the covenant can be broadly demonstrated by reference to regulated superannuation generally and the approach of APRA to the original covenant. In particular, the existence of member investment choice has escalated the role for members and reduced the extent to which the trust law duty to invest can provide suitable guidance to trustees. Arguably, the exercise of such a choice by a member could dilute the duty of a trustee to merely creating investment strategies and implementing a member's choice, without regard to the suitability of that choice for the member's circumstances. Adopting that approach would mean that the original covenant had little in common with the

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[265] Scott Donald, 'Prudence under pressure' (2010) 4 *Journal of Equity* 44, 62-63.
[266] Gino Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) [22.195].
[267] Scott Donald, 'Prudence under pressure' (2010) 4 *Journal of Equity* 44, 63.

nature of the duty to invest arising under trust law. The view of APRA appears to adopt a middle ground on this point, as reflected in the following comments in SC II.D.1:[268]

> The guidance provided in this circular is not intended to significantly impinge on the choices that trustees can offer and members make. Rather, it focuses on trustee protection of members' interests by means of sound processes and policies to manage investment risks.

and later:[269]

> In APRA's view, it is difficult to conclude that a trustee is acting in the best interests of members if narrow or risky choices are made available without regard to the amount or proportion of the member's interest that may be placed in the particular strategy.

The first passage in APRA's statement tends to indicate that, in light of member investment choice, the duty to invest operates to ensure that a trustee is responsible for the process that enables a member to exercise their choice. That is, the trustee is responsible for setting the parameters to that choice so that investment risk is properly managed. The second passage goes further by identifying the need to consider the allocation of a member's superannuation interest between different strategies. The suggestion is made that where members that are heavily invested in a narrow or risky option, trustees could consider providing such members with "health" warnings.[270] Thus, in APRA's view the purpose of the original covenant is to ensure that trustees make appropriate decisions to protect beneficiaries' retirement benefits by identifying and managing risks, and ensuring that investments are made in accordance with the sole purpose test and related investment restrictions.[271] That explanation continues to identify to some extent with trust law and the importance placed on the role of trustees to protect the interests of members.

However, that conclusion is not necessarily suitable for the SMSF without further consideration of context. As the substance of the SMSF is a mechanism for self-directed investment, the operation of the covenant in so far as its intent is to "protect" beneficiary's retirement benefits is truly concerned with protecting beneficiaries from their own decisions. Therefore, when members adopt the SMSF structure so as to take control of their retirement

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[268] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [37].
[269] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [45].
[270] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [45].
[271] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [4].

savings, it is the investment decisions of those members that are in substance addressed by requirements of the covenant. Whilst the documentation of the investment strategies of the SMSF are signed by the members as trustee, it is trite to suggest that members wear any other hat than their own personal interest when formulating and implementing those strategies.

Given that the covenant more accurately applies to the decisions of the SMSF member, there is once again a strong basis to demonstrate why trust law guidance is unsuitable. An approach more closely aligned to the substance of the SMSF is to adopt the alternative conclusion that the covenant accommodates contemporary investment theory, but leaves it open to the court to determine what theory is appropriate to the particular circumstances under consideration. On that basis, whether amounting to MPT or not, diversification is accepted in contemporary investment theory as means of reducing portfolio risk and is something that expressly needs to be considered under the covenant.

Having resolved that diversification is an important consideration both under contemporary investment theory and is specifically addressed in the covenant, it is useful to consider the circumstances of the SMSF that may determine that non-diversified investment is appropriate. That is particularly important given the statistical evidence suggesting that, rather than diversifying their investments, SMSFs have on average historically tended to allocate significant proportions of their portfolios to cash assets.[272] Whilst acknowledging that cash assets may carry a broad range of risk, to the extent that they reflect low levels of risk it is plausible that after considering the benefits of diversification the decision was made by these SMSFs to adopt a capital preservation strategy. The relatively low rates of non-compliance in comparison to the number of SMSFs adopting a non-diversified heavily cash weighted portfolio suggests that the ATO does not consider compliance action is necessary.[273]

In the SMSF context contemporary investment theory must also exist alongside particular features of the SISA that provide flexibility to invest in ways that allow or arguably encourage the concentration of investment risk. For example, the principal activity of an SMSF may involve ownership and leasing of BRP to members and Part 8 associates of the fund.[274] Limited recourse debt facilities are also increasingly being marketed to the SMSF

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272 Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper*, 3 (unpaged).

273 As at 30 June 2016 only 1.6% of the total population of SMSFs had an auditor contravention report for the 2013-2014 income year. The most commonly reported contraventions involved loans and financial assistance to members, in-house assets and separation of assets, the sole purpose test and borrowings. Refer Australian Taxation Office, *Commissioner of Taxation Annual Report 2015-16* (2016) Vol 1, 66.

274 Refer SISA s 71(g).

sector to enable real property investment, potentially causing all of the resources of an SMSF to be directed to a single property.[275] However, whilst that level of risk concentration would be likely to concern trustees of non-SMSF regulated superannuation funds, their members and the regulator, that may not be the case for the SMSF.[276] First, it would not concern SMSF members because they would have considered the matters in the covenant and agreed to implement the strategy. Second, both examples are activities that are specifically provided for in the SISA. Third, there is little published evidence in the way of rulings or compliance action from the ATO to suggest that these activities are inappropriate.

The flexibility of the covenant and different levels of SMSF portfolio diversification would suggest, at least from the perspective of investment theory, sub-optimal retirement incomes. That outcome would lend support for increased restrictions to limit SMSF investment choices, both in terms of the assets that are permissible and the weighting of asset classes within a portfolio. However, the extent of any further restrictions would need careful thought, particularly given that overweight cash portfolios led many SMSFs to outperform other categories of regulated superannuation fund during the recent Global Financial Crisis[277] (GFC). Any change would need to be mindful of the SMSF context and, as Megarry V-C in *Cowan*[278] observed, "[t]he degree of diversification that is practicable and desirable for a large fund may plainly be impracticable or undesirable (or both) in the case of a small fund".

4.4.5 *Consequences for the SMSF*

The relevance of the trust is assured by its endorsement in the SISA as the legal framework for the SMSF. Yet the role of trust law duties that are expected to follow from the adoption of that structure is difficult to decipher. This is largely due to the enactment of the covenants and uncertainty surrounding whether they clarify or codify the duties of an SMSF trustee. Ultimately, the prevailing view is that they do not simply restate the general law but are statutory enactments. Accordingly, the covenants and trust law duties combine as a hybrid body of rules. The covenants play the predominant role, with trust law having application only to the extent that it is capable of operating concurrently with the SISA. As a matter of interpretation, while trust law may be instructive, the covenants should not be presumed to simply reflect antecedent laws.

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275 Refer SISA 67(1), 67A; SISR reg 13.15.

276 Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [28]-[33].

277 Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper* 3 (unpaged).

278 [1985] Ch 270, 289.

Given the breadth of the covenants, the scope for contribution by trust law to the SMSF is largely interpretative. The extent of this contribution is revealed by analysing the covenants, split into those that relate to trustee conduct, management and investment. The first of these categories includes a duty of honesty, an ordinary prudent standard of care and the duty to act in the best interests of beneficiaries. On close inspection the creation of an independent duty to act honestly has little basis in trust law. The duty to adopt an ordinary prudent standard of care also differs from its trust law counterpart. While trust law standard is that of an ordinary prudent person experienced in business, it is odd that the covenant would place such a standard on SMSF trustees, who are not otherwise required to possess business acumen. Differences also arise between the duty to act in the best interests of the beneficiaries and its trust law equivalent, putting aside the uncertainties surrounding the content of the trust law obligation. As a matter of principle, when the SMSF is viewed as a mechanism for self-directed investment, it is difficult to see how decisions made by members for their own benefit would not be in the own best interests. These obstacles are largely overcome where the covenants adopt their ordinary meaning and administrative context.

The covenants that address management include duties on the separation of assets and preventing or hindering a trustee from properly performing their functions and powers. The first duty correlates to the trust law requirement not to mix trust moneys with the trustee's own moneys. However, the reason to maintain separation of superannuation fund assets from those of the trustee that are held personally (or employer-sponsor) is to maintain integrity of the retirement income objective. In particular, for the SMSF it prevents members using fund assets for their own non-prescribed purposes or intermingling their personal assets so as to inappropriately access the taxation benefits of superannuation. In this context, it is inapt to explain the covenant by reference to trust law. In relation to the second duty, it is doubtful whether the conservative approach embodied in trust law is appropriate to resolve the standard of the word "proper". That is especially the case for the SMSF, where in substance there are no "other person's assets" for which a trustee is responsible. Once again, both covenants can be interpreted without recourse to trust law.

Finally, the covenant on investment contains a duty to formulate, review and give effect to an investment strategy. While the trust law duty of a trustee to invest trust funds correlates to this requirement, the criteria adopted in the covenant to guide the construction of an investment strategy are not unique to trust law. Furthermore, the statistical analysis in Chapter 3 of this thesis suggests that many SMSFs quite acceptably do not include diversification as part of their investment strategy or subscribe to MPT. To some extent this concentration of investment risk is actually encouraged by SMSF-specific modifications in the SISA, such as permitting BRP to be leased to related parties and limited recourse borrowing. In light of these matters, guidance from trust law is not warranted.

4.5 Synthesis

The endorsement by the SISA of a trust framework for regulated superannuation means that the trust is undeniably relevant to the SMSF. However, notwithstanding its relevance, the purpose of this chapter has been to demonstrate that the relevance of trust is clearly not synonymous with its suitability. This position was substantiated though a broad examination of the trust architecture upon which the SMSF relies, followed by a dissection of certain fiduciary and trust law duties arising at general law that follow the adoption of that structure.

The difficulties with the trust framework have arisen due to the evolving nature of regulated superannuation, which has moved a long way from its trust law origins. The change has been particularly influenced by employment, financial and public contexts that have eroded the suitability of the trust law framework. When the analysis moves from non-SMSF regulated superannuation to the SMSF, the unsuitability of the trust by reference to these factors becomes is even more pronounced. In addition, the SMSF is unique in that despite adopting the trust form, the SMSF is accurately described in substance as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. The inconsistency between this substance and the basic notions of a trust is a particularly awkward outcome for the SMSF.

The fiduciary and trust law duties that follow the adoption of the trust structure provide further grounds to demonstrate the trust is not a good fit for the SMSF. First, contribution of fiduciary duties to regulated superannuation is somewhat restricted given that their objectives do not necessarily align with the retirement income objectives contained in the SISA. In addition, when their application narrows to the SMSF, they uncomfortably address the decisions by member(s) that those individuals have endorsed and made for their own benefit. Secondly, the operation of the covenants in the SISA means that trust law duties are left with a limited role. When analysed by reference to the substance of the SMSF, the covenants are shown to be a series of stand-alone and self-contained requirements that are suitably interpreted without the guidance of trust law. In a number of instances, trust law guidance is liable to mislead SMSF participants and produce unnecessary complexity.

Having substantiated the grounds to show that the trust is unsuitable for the SMSF, it is constructive to suggest what changes might be made to remedy this situation. Once again, the identified substance of the arrangement is central to that task. The most effective and efficient approach is to make changes to the legal framework that better accommodates or optimally endorses the SMSF substance. Two alternative ways of doing this are set out in Chapters 5 and 6.

PART THREE – CONTEXT REASSEMBLED

CHAPTER FIVE: WORKING WITH THE TRUST

5.1 Introduction

Given the analysis in Chapter 4, it is evident that the trust and core incidents of trusteeship following the adoption of that structure are frequently unsuitable for the SMSF context. That position was reached by moving beyond historical reverence for the trust to a detailed analysis of how regulated superannuation has evolved over time as part of Australia's retirement income system, including the now prominent role of the SMSF. Significant emphasis was placed on the public and financial contexts in which the SMSF operates. Those contexts shape the true characterisation of the vehicle, as a mechanism for self-directed member investment encouraged through taxation concessions but limited by SISA-prescribed restrictions. However, a further question arising from Chapter 4 and which is considered in this chapter is how the unsuitability of the trust framework can be addressed.

The initial and prudent step is to undertake further examination into the SMSF substance by reviewing the work on the SMSF undertaken by the Review of Australia's Superannuation System[1] (Cooper Review). The Cooper Review devised a set of ten guiding principles that should underpin SMSF regulation, which it applied in considering a range of SMSF specific structural issues. In examining the legal framework for the SMSF, the role of the trust was questioned though ultimately support was given for its retention. On that basis, it is reasonable to initially proceed on the basis that the trust will remain, though its suitability may be improved by better accommodating the substance of the SMSF within that legal framework.

Adopting this approach, one avenue to improve the suitability of trust framework is to dilute the significance of the general law principles and trustee centricity that follow that structure. To be persuasive, the approach should be explained using legal principles, rather than emotive reverence often repeated to support retention of the trust. That is, what is it about the legal position of a member vis-a-vis their interests in SMSF assets that justifies the departure? Useful insight on that question can be gained from instances where, despite the adoption of the trust structure, the expected general law principles are displaced to achieve some higher policy objective.

The identified theme in situations where this displacement occurs, by reference to receivership, family law and tax law contexts, is that the parties to the trust have reached a requisite degree of control and/or benefit from its activities. The trust legal framework is then developed so that the trust property is attributed to the individuals concerned, rather than maintaining the strict legal divisions that would be the case under general law. Applying that approach to the SMSF, the trust property could be regarded as assets of the members for regulatory purposes and justify a direct application of

1 Superannuation Review Panel, *Super System Review* (2009).

restrictions to the member participants, rather than persisting with the veil of trusteeship. While the role of the trust is limited, the fact that it is not abandoned makes the change less controversial and more likely to garner support.

5.2 Recognising substance – a member focussed approach to regulation

5.2.1 Adoption of a choice architecture

During the course of this thesis various references have been made to the Cooper Review. Although there have been a range of Commonwealth Government (Government) sponsored enquiries into aspects of regulated superannuation, the work of the Cooper Review is important in providing a holistic and recent examination of Australia's superannuation system, including the role of the SMSF. The comprehensive nature of the inquiry was possible due to its broad terms of reference to examine and analyse the governance, efficiency, structure and operation of Australia's superannuation system, including, but not limited to, the following issues:[2]

> **1.1 Governance:** examining the legal and regulatory framework of the superannuation system, including issues of trustee knowledge, skills and training; and thoroughly assess the risks involved in the use of debt and leverage and the development of investment options that lead to a weakening of the diversification principle in the superannuation system;
>
> **1.2 Efficiency:** ensuring the most efficient operation of the superannuation system for all members, whether active or passive members and whether making compulsory or voluntary contributions, including removing unnecessary complexities from the system and ensuring, in light of its compulsory nature, that it operates in the most cost effective manner and in the best interests of members;
>
> **1.3 Structure:** promoting effective competition in the superannuation system that leads to downward pressure on system costs, examining current add-on features of the superannuation system; and, examining other structural legacy features of the system; and
>
> **1.4 Operation:** maximising returns to members, including through minimising costs, covering both passive defaulting members, who should receive maximum returns and value for money through soundly regulated default products, and active selecting members, who should not be negatively impacted by conflicts of interest that may inhibit advice being in the best interests of members.

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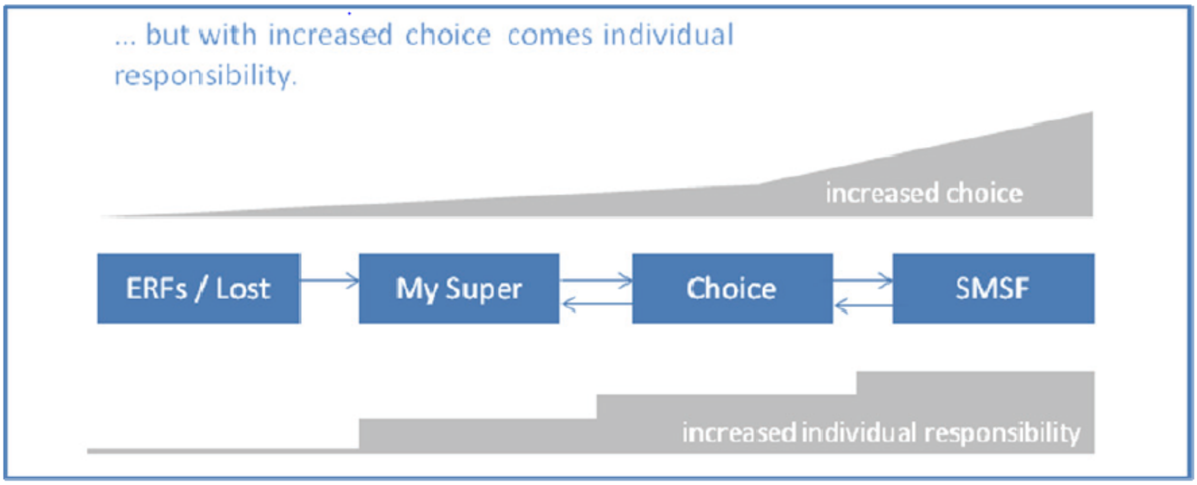
[2] Superannuation Review Panel, *Super System Review terms of reference* (2009) <http://www.supersystemreview.gov.au/content/content.aspx?doc=terms_of_reference.aspx&pageid=006a>.

The 2010 Super System Review Final Report[3] (Cooper Report) was largely premised on the conclusion that, in order to position the superannuation system for future challenges, it was necessary to re-examine the architecture upon which that system relies. Consistent with the views in this thesis, a concern with the existing regulatory infrastructure supporting the superannuation industry was the degree to which it distinguishes between the different regulated superannuation fund models.[4] Although at the margins there are distinct rules applicable to public offer funds, standard employer-sponsor funds, defined benefit plans and SMSFs, the SISA proceeds on the basis that there can be a single model of fund governance. Given the development of the superannuation industry since the enactment of the SISA, the Cooper Report advised that such a view could no longer be maintained.[5] While the one-size-fits-all approach appears equitable, it can be a poor fit in practice, offering an illusion of protection in some cases and demanding primacy of member interests in others, causing unnecessary complexity and excessive costs.[6]

The Cooper Report resolved that the governance model for regulated superannuation should be capable of addressing not only disengaged members, but engaged members wishing to exercise investment or fund choice. To meet that objective, a member-focussed "choice architecture" was proposed. That approach starts with the member, rather than a product or industry sector perspective, and classifies them into one of three main models: MySuper, Choice and SMSFs. The category under which a member will fall is determined according to whether they have made a choice about their interest in regulated superannuation, and if so, the nature of that choice.[7] The framework therefore accommodates (but does not impose) choice upon a member. The extent that a member exercises choice will correspond with increased responsibility for their superannuation affairs. The Cooper Report illustrated this relationship as follows:[8]

3 Superannuation Review Panel, *Super System Review Final Report* (2010).
4 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 6.
5 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 6.
6 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 6.
7 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 6.
8 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 7.

Figure 1.2: Increased choice, increased member responsibility



Under the choice architecture the lowest degree of choice accommodates disconnected members, whose superannuation interests have been lost or unclaimed. Beyond that category, where a member chooses to participate in regulated superannuation, the next level of choice is represented by MySuper. Members in this category exhibit some degree of engagement, though they do not wish to take part in decision making. Next is the Choice category, applicable to members who seek to exercise some degree of choice to tailor their superannuation, and in doing so accept some responsibility for their decisions. At the apex is the SMSF, accepted as the extreme for member choice and responsibility. The Cooper Report described the SMSF as recognising "that some people have the desire and capacity to manage their own retirement savings and choose to assume full responsibility and control".[9]

Having regard to these distinctions, the Cooper Report emphasised the need for clarity about the differences between the choice categories and what those differences meant for a trustee's duties to the member.[10] Although the word "choice" rather than "context" was adopted as the basis to explore the relationship between a member, their superannuation interests and trustee responsibilities, there is broad consistency of approach between the Cooper Report and the preceding analysis in Chapter 4. In both cases there is a recognised need for detailed analysis of how participants actually conduct themselves in practice. They endorse a focus on the substance of the arrangement, rather than persisting with the historic tendency to characterise all types of regulated superannuation under a single model and set of principles. In the SMSF context, the substance of the relationship as a mechanism for self-directed member investment is synonymous with the "choice" by a member to take control and accept full responsibility for their retirement savings.

9 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 7.
10 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 6.

5.2.2 SMSF principles within the choice architecture

Although it is possible to apply the broad choice architecture principles to develop a responsive SMSF regulatory framework, a more expedient approach is to examine the further specific coverage that the SMSF received in the Cooper Report. Recognising that the SMSF sector has different characteristics in comparison to the other types of regulated superannuation within the choice architecture, the Cooper Review determined that they merited separate investigation.

To maintain faith with the adopted choice architecture, it would not have been persuasive or consistent with that model to simply acknowledge the existence of the trust framework followed by a generic discussion of the important core incidents of trusteeship. A member-focussed enquiry requires a more sophisticated analysis to recognise the overriding importance and role of SMSF members, while at the same time accepting that the SMSF has as a matter of law adopted the trust structure. Accordingly, no matter how estranged members may have become in practice, their role could not be considered in complete isolation from that framework. What ensued was an uneasy mix of principles, reflecting the legal structure of the trust, but also the substance of the arrangement. At some points the latter consideration made significant ground, as is evident in the following statement:[11]

> Member/trustees are, therefore, ultimately responsible for their own decisions and for the adequacy of their retirement savings.

Yet the statement also highlights the difficulty of articulating exactly what the SMSF is about. Decisions concerning the conduct of the SMSF are made by trustees, but all members must necessarily be trustees or directors of a trustee company. On that basis, acknowledging the chosen trust structure supports a conclusion that responsibility for SMSF decision making should be properly described as falling to the trustees. That conclusion is consistent with the fundamental trust law duty surrounding trustee investment. However, if the member-focussed approach of the choice architecture is adopted, the fact that all SMSF members are trustees or trustee-directors raises additional implications. If the substance of the arrangement is that members control and benefit from SMSF decision making (albeit decisions made in their capacity as trustees), it seems more accurate to conclude that members bear ultimate responsibility for their own decisions. The adoption of the expression “Member/trustees” conveniently covers both approaches, although it is not particularly helpful to resolve the matter. The importance of the member emerges again in the subsequent reference to the adequacy of “their” retirement savings, which more accurately can only mean a reference to the retirement savings of the member.

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[11] Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 218.

Whether due to the comfort of maintaining the existing approach, a preference to avoid disruption or practical need to simply conclude one way or the other, the very next statement made in the Cooper Report begins to apply weight to the importance of the trust framework. The case for broad-ranging reform accommodating the SMSF substance and implementing the member centric approach expected to follow from early comments in the Cooper Report dissipates to refocus on the SMSF trustee:[12]

> As SMSF trustees have ultimate responsibility they can choose to be entirely self-directed and self-sufficient (that is make investment decisions and look after the SMSF's administration and compliance obligations) or they can delegate, part or all of, these functions (but not responsibility) down to service providers (for example accountants, financial planners and administrators).

On one view of the SMSF this explanation is entirely appropriate. Following the adoption of the trust framework it is the trustees who have ultimate responsibility for investment decisions, both under the SISA and at general law. On that basis, there is little reason to cloud the issue by using the expression "Member/trustee". However, omitting any reference to members or the fact that they are all necessarily trustees or directors of a corporate trustee pursuing their own interests tends to simplify the SMSF relationship. It is important to observe that it is the members themselves that choose the SMSF route in the first place, attracted by greater autonomy over investment decisions in comparison to other forms of regulated superannuation. The location of responsibility for the SMSF is torn between whether the trust framework or substance of the arrangement is adopted, though publicly acknowledging that misalignment would have been a courageous step.

The Cooper Report then proceeded to identify 10 guiding principles previously drafted in the Self-managed Super Solutions Phase Three – Preliminary Report[13] (Cooper Preliminary Report) to underpin SMSF regulation. This approach enabled a range of SMSF related principles to be identified, without having to resolve the inconsistencies between earlier statements and validate the extent to which they should reflect the trust framework or substance approach. The principles to some extent align with the SMSF context developed in this thesis and the overriding importance of the member. Initially, they support the characterisation of the SMSF as a mechanism for self-directed investment. However, consistent with the adoption of the trust framework, the guidelines are also directed to the role of the SMSF trustee, though less frequently than might be expected given the recommendation to retain that framework. The set of guiding principles are set out as follows:[14]

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12 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 218.
13 Superannuation Review Panel, *Self-managed Super Solutions, Phase Three – Preliminary Report* (2010) 1-3.
14 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 218-221.

Principle 1 — Ultimate responsibility

SMSFs are unique in Australia's superannuation system in that SMSF members have effectively assumed sole responsibility for their retirement savings. This affects a wide range of regulatory settings that are appropriate for SMSFs.

Principle 2 — Freedom from intervention

Given that SMSF members are entirely responsible for their own decisions (principle 1), the Panel sees the ability to be genuinely self-directed and self-sufficient as an important feature of SMSFs. The Panel believes that trustees should not lightly be exposed to administrative and other burdens that are not directly relevant to building their retirement savings through sound investment practices.

Principle 3 — ... but not complete absence of intervention

All superannuation funds, including SMSFs, benefit from valuable tax concessions that are designed to encourage and help members to save for retirement. In addition, the government underwrites the risk of SMSF failure via the social security system. The Panel believes that this justifies *some* intervention in the way SMSFs are managed and that the community also has a right to a certain level of information about them. That intervention is currently reflected in a range of rules and restrictions in the SIS Act and associated regulations.

Principle 4 — Service providers

Consistent with the first three principles, trustees are not required to use a service provider when running an SMSF, other than the annual audit, which must be carried out by an approved auditor. SMSFs might also choose to use a range of other service providers (for example, administrators, platform providers and accountants) and these service providers also play an important role in the SMSF sector. As a result, the Panel believes that government policies should be directed at ensuring service providers maintain a high standard of competency and compliance as part of the overall regulatory framework. Where appropriate, licensing should be used to achieve this, but only in a way that demonstrably adds value to the sector.

Principle 5 — Appropriate entry into SMSFs

The Panel believes that the viability of the SMSF sector is strongly dependent on the composition of its population. An influx of trustees who were less well-equipped to cope with the responsibilities and disciplines inherent in running an SMSF could lead to serious public policy concerns for the sector. Such a development could see a call for more severe regulatory restrictions on all SMSFs which would be to the detriment of all existing members and the sector as a whole. The Panel recognises that this Review could create an interest in SMSFs from people who would, in fact, be better off remaining in large APRA funds.

Within the choice architecture model, members have the right to choose; as such the Panel does not believe there should be artificial impediments to members entering the SMSF sector.

The Panel believes that members who wish to form an SMSF without advice should be able to continue to do so. However, the vast majority of people do so based on advice from professional service providers. Consequently, the Panel strongly believes that advice standards need to be high within a robust regulatory framework to ensure members are not being inappropriately advised into the product.

Principle 6 — Consistent treatment with large APRA funds where appropriate

The Panel believes that the norm should be that all superannuation funds are treated in the same way. For example, notwithstanding that outcomes might differ because of fund size, scale and other individual fund circumstances, the same tax legislation, sole purpose and preservation rules should apply across all sectors. This suggests that many rules for SMSFs will be the same as those applicable to large APRA funds and that is in fact the case.

However, there is no escaping the fact that SMSFs are different and that they call for different rules in a number of areas. It is not always appropriate or desirable that all superannuation funds should operate under precisely the same legislative framework. The Panel recognises that this runs counter to many submissions that argued their particular position on the basis of a 'level playing field'. However, the Panel has specifically taken the view that consistency with large APRA funds will not always be appropriate for SMSFs. This position also reflects the distinct supervisory approach necessarily applied by the ATO and APRA to their respective superannuation populations.

Principle 7 — Recognition of special risks in an SMSF environment

Extending principle 6, the Panel recognises that the SMSF environment creates some particular tensions in appropriately managing the personal preferences and lifestyle choices of the members (and their related entities). While trustee decisions for all funds are made within the framework of the sole purpose test, the Panel believes that it is appropriate to impose *some* additional restrictions on SMSF trustees (over and above the restrictions imposed on funds with an external trustee) given those tensions.

Principle 8 — Leverage

Leverage should not be a core focus for SMSFs. While views will differ on this issue, the Panel believes that there is room for leverage in SMSFs, but it should be ancillary to the main strategies employed to build retirement savings over the longer term.

Principle 9 — Compliance, rather than prudential, regulatory focus

An important element in the supervision of large APRA funds is ensuring that trustees are acting in members' best interests at all times. In the Panel's view, a different regulatory focus is appropriate for SMSFs. The role of the regulator and key industry participants (such as auditors) for this sector should be legislative compliance, rather than a prudential objective.

Principle 10 — Pursuit of excellence

Given that SMSFs are widely dispersed and non-institutionalised, and that many SMSF service providers are also fragmented and lack scale, there is a challenge for the sector in investing in improvements such as technology, governance and investor education. The Panel believes that a sector that has such a large proportion of Australia's retirement savings needs an aggressive agenda aimed at pursuing excellence across all its activities. The Panel believes that it might be worthwhile for government to consider measures to support, promote and champion the development of best practice among SMSF trustees.

Although there is no specific reference to any ordering priority between the principles, it is arguable that some significance could be placed on their arrangement, given that a number of later principles are expressed to be consistent with or build upon earlier principles. In that regard, the importance of the member is reiterated in the first two principles. Principle 1 is fundamental in emphasising that "SMSF members have effectively assumed sole responsibility for their retirement savings". That statement is consistent with the substance of the SMSF identified in Chapter 4 and is unconcerned with the legalities of the trust framework that would otherwise accord responsibility to the trustee. The member focus continues in Principle 2, which after recognising member responsibility (Principle 1) emphasises the importance placed on the "ability to be genuinely self-directed and self-sufficient".[15] After these initial principles the degree of member-centricity dissipates and the focus can broadly be divided between those directed at the SMSF itself (as an entity or object), the trustees and hybrid statements addressing both the trustee and SMSF.

Principles 3, 6 and 8 are directed at the SMSF as the subject matter. Principle 3 is reflective of the financial and public context of the SMSF addressed in Chapter 4 to yield the substance of the arrangement as a mechanism for self-directed investment that requires regulatory intervention. Principle 6 supports uniformity between the regulatory and taxation treatment of the SMSF and APRA-regulated superannuation funds, with some exceptions to accommodate their unique features and different supervisory approach. In that regard, the ATO's compliance focus is particularly aligned with treating the SMSF as an object rather than a relationship of trust, which has either complied or not complied with the tax and superannuation laws. Principle 8 is concerned with leverage, which following the need for consistency with APRA-regulated funds should not be a core area of focus for the SMSF. In focussing on the SMSF as the object for regulation, this group of principles does not seek to resolve whether at a detailed level the mechanism operates through trustee conduct or is self-

15 The later part of Principle 2 deviates to some extent from the member focus, referring to trustees administrative and other burdens to building their retirement savings. That is reasonable given that trustees do currently bear the burden of SISA regulation, though consistent with earlier comments is misleading in referring their (i.e. trustees') retirement savings rather than the savings of members.

directed by the members. Irrespective of that issue, all such activity should be subject to restriction that is, with limited exception, consistent with APRA-regulated funds.

Principle 7 is the only principle to be directed solely towards SMSF trustees. Adopting a trustee-centric approach, it recognises that the preferences and lifestyle choices of members may create tension for trustee decisions. Despite those decisions already being subject to restrictions in the SISA, it was considered that *some* additional restrictions for SMSF trustees were warranted. The principle recognises the influence of members, though from the perspective of the desires they hold in their private capacity. Yet since all members are necessarily trustees or directors of the corporate trustee and the SMSF must be conducted for the sole purpose of supporting retirement incomes, the distinction between separate trustee and member preferences is difficult to maintain. Given the substance of the SMSF, the need for further restriction would arguably be better expressed in a statement that applied to the members themselves or the SMSF as the object through which their activity occurs.

Principles 4, 5, 9 and 10 straddle both the trustee and the SMSF as the object of regulation. The preparedness to interchange these terms creates some awkwardness. Principle 4 concerns the trustees' choice to use external service providers, beyond an approved auditor. Yet the principle also elaborates that SMSFs (rather than trustees) might choose to use a range of service providers. It is difficult to see how the SMSF, as distinct from its trustees, could engage service providers. Arguably, the reference to the SMSF partially recognises the substance of the arrangement, being the mechanism through which the decisions are made, though stopping short of also recognising that the members in substance comprise the SMSF. Principle 5 concerns the potential influx of trustees who are less capable of running an SMSF. However, rather than leading to the greater trustee restriction, the development is explained as leading to further restriction on all SMSFs, again being the mechanism through which investment occurs. Principle 9 contrasts the importance of ensuring that APRA-regulated fund trustees act in the best interests of members with the non-prudential compliance based approach for the SMSF. Reference to the SMSF rather than its trustees follows the compliance model, primarily focussed on the SMSF as an object of regulation that has complied or not complied, rather than having concern for general law incidents of trusteeship. The limited significance of prudential objectives aligned with trusteeship is consistent with the absence of SMSF member loss recovery mechanisms under the SISA and the expectation that since all SMSF members are trustees or trustee-directors they would act in their own best interests. Principle 10 identifies that SMSFs are widely dispersed and non-institutionalised, giving particular challenges to their pursuit of excellence, before referring to best practice among SMSF trustees. While recognising the SMSF as the object of regulation, the principle reverts to the trustees to pursue best practice.

Collectively, the principles illustrate the unique position of the SMSF, whose regulatory principles go beyond the trust framework and trustee responsibilities. Although some trustee-centric discussion was necessary, it proved insufficient to explain all principles. The role of the member could not be overlooked, even though the Cooper Report appeared wary of emphasising its substance as self-directed member investment, more often simply referring to the SMSF. Before proceeding to make recommendations based on these 10 principles, the Cooper Report explained its vision for the SMSF. That vision was one where trustees act diligently to build their retirement savings and are supported by highly competent and skilled service providers, with approved auditors and financial advisers having a greater "gate keeping" role to ensure that those in the SMSF sector are more likely to cope with its challenges.[16] Importance was placed on the sector's ability to be innovative, efficient and well-managed and largely free of asset-based or percentage fees.[17] SMSFs should be simple for trustees to operate and manage; through improved efficiency, greater use of technology, more effective regulation and better governance.[18] Trustees should be supported with access to information that is relevant, reliable and comparable, enabling the costs of running a SMSF to be determined, comparisons with other forms of regulated superannuation to be performed and facilitating better decision-making.[19] Trustees should be focused on investing for their retirement and not on related party or present day benefits; and the risk of illegal schemes and fraud would be mitigated so as to make SMSFs safer.[20]

Despite the fact that many of the guiding principles were directed at members or the SMSF, the dominant theme is that the matters in the vision concern the trustee. That approach is likely to create confusion with the choice architecture and the role of SMSF members. For example, the vision expects trustees to act diligently to build *their* retirements savings and that trustees are focused on investing for *their* retirement. It is difficult to accept that explanation when the basic trustee duty is to invest trust funds, not for their own benefit, but for the beneficiaries concerned. It is possible that, as all members are trustees or directors of the corporate trustee, the terms "trustee" and "member" were considered interchangeable for those purposes. The adoption of the phrase "Member/trustee" may have provided a compromise were this the case, while still maintaining a degree of trustee focus. Disappointingly, the word "member" is omitted from any part of the vision, despite Principles 1 - 3 reiterating the importance that members accept sole responsibility for their retirement savings and are self-directed.

16 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
17 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
18 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
19 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
20 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.

5.2.3 The trust structure endures

The start of consultation on Phase 3 of the Cooper Review coincided with the release of a Phase Three Structure Issues Paper[21] (Issues Paper). In relation to the existing SMSF trust framework, the Issues Paper raised the following question:[22]

> SMSFs, like other superannuation entities, are trust (and tax) structures that are governed by their trust deed and the SIS Act, which also specifies obligations of trustees that automatically form part of the SMSF's governing rules. An alternative model would be for SMSFs (and the rules that govern their operation) to be created by legislation, rather than by private instrument. A SMSF could then be created simply by completing an approved form and paying a prescribed fee to the ATO.
>
> Alternatively, a standard trust deed could be provided by the ATO at no cost. Trustees could elect to opt-out of the standard trust deed and use their own if they wished.
>
> *Would either of these approaches save costs and benefit new SMSF members?*

After reviewing submissions received on this question, the Cooper Report observed widespread support for the retention of the trust.[23] It referred to its earlier support for the trust structure in the APRA-regulated sector[24] and saw no reason why the SMSF sector should operate under a different structure (such as a statutorily formed trust or a purely contractual structure) given its substantial size, history and the costs and challenges in replacing it.[25] With respect, that reasoning is unfortunate. While many principles apply to regulated superannuation as a whole, the Cooper Report expressly recognised that the SMSF sector has a number of different and unique characteristics.[26] On that basis, an entire chapter was dedicated to giving the SMSF separate consideration, with significant effort made to formulate the guiding principles for SMSF regulation, rather than being influenced by the APRA-regulated sector. In addition, while the retention of the trust framework was overwhelmingly supported by submissions, that in itself is not compelling without evaluating the reasoning behind those submissions. In that regard, many submissions relied on a historic reverence for the trust, generic observations on trusteeship and inadequate consideration of the SMSF context, meaning they are not overly persuasive.[27]

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21 Superannuation Review Panel, *Phase Three Structure Issues Paper* (2009).
22 Superannuation Review Panel, *Phase Three Structure Issues Paper* (2009) [21.1].
23 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
24 Superannuation Review Panel, *Clear Super Choices: Matching Governance Solutions* (2009) [6.2].
25 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 221.
26 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 218.
27 For example: Law Council of Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 19 February 2010, 13; Institute of Chartered Accountants in Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 26 February 2010, [8.1];

Without further explanation, the observation that the SMSF sector is now a substantial size is an unconvincing reason to retain the trust framework. If anything, the growth in the SMSF sector heightens the need to ensure that its legal framework remains fit for purpose. Similarly, although the trust has a rich history, that history cannot supplant the need to go beyond broad principles and accept that context is critical. The trust is relevant to the SMSF due to statutory prescription, but that does not make it suitable for the substance of the arrangement. While costs and challenges of replacing the trust framework are important considerations, no detailed evaluation of those obstacles was given to enable proper scrutiny. The Cooper Report also failed to recognise that, apart from complete abandonment of the trust framework, there are a range of possible reforms that could limit its regulatory significance, such as retaining the framework but having statute recognise the connection between members and SMSF assets. Given the breadth of matters covered by the guiding principles, it would have been open to the Cooper Report to recommend retention of the trust structure by giving particular weight to those principles that were more trustee-centric. Although that approach might still be criticised for moving away from the member-focus of the choice architecture, it would nonetheless present a stronger argument than one influenced by what was appropriate for APRA-regulated superannuation funds.

Following the endorsement of the trust framework, the Cooper Report proceeded to make a number of supporting statements consistently phrased in a trustee-centric manner. It emphasised the ability to retain control over all aspects of an SMSF as a very powerful and attractive feature for trustees, and that submissions overwhelmingly supported the retention of control, as did the Panel.[28] However, while control is universally recognised as an important feature and attraction of the SMSF, it is perhaps more typically explained by reference to member control. For example, that approach appears in the Australian Taxation Office (ATO) explanation that “the members of the SMSF run it for their own benefit” and the emphasis that “if you set up a self-managed super fund (SMSF) you’re in charge”.[29] It would be surprising if the Panel was unaware that SMSF control is viewed from a member perspective, though they may have been reluctant to allow intermingling of principles. This hesitation may also explain their subsequent statement that inherent in the concept of control is the recognition and acceptance that ultimate responsibility rests with the trustees.[30] That observation lies

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Superannuation Professionals Association of Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 26 February 2010, 12; CPA Australia, Submission to Super System Review Panel, *Super System Review – Phase Three: Structure*, 19 February 2010, 8.

28 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

29 Refer Australian Taxation Office, *Self-managed super* funds (7 December 2016) <https://www.ato.gov.au/Super/Self-managed-super-funds/>; Australian Taxation Office, *Thinking about self-managed super* (29 October 2015) <https://www.ato.gov.au/Super/Self-managed-super-funds/Thinking-about-self-managed-super/>.

30 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 222.

in stark contrast to the way that guiding Principles 1 and 2 were expressed, namely that SMSF members have effectively assumed sole responsibility for their retirement savings and are entirely responsible for their own decisions.

5.2.4 Consequences for the SMSF

The Cooper Review made a useful, though non-exhaustive, contribution to analysing exactly what the SMSF is about. Continuing from early remarks in the 1997 Financial System Inquiry Final Report[31] (Wallis Report), the Cooper Report disclosed some willingness to pick through unhelpful generalisations stemming from the trust framework to reveal the substance of the SMSF. In doing so, it confronted a difficult and unchartered course. While the substance of the SMSF is accurately explained in the member-centric manner adopted in this thesis, many of its recommendations were constructed without using that approach.[32] A common line was to explain principles using the SMSF as an object of regulation. Although there is logic to support that approach on the basis that the SMSF is the statutory mechanism through which the self-directed member investment occurs, the Cooper Report did not adopt that explanation. Instead, many principles concerning a SMSF choosing or undertaking some action were described in different parts of the same statement as the action of trustees. Thus, rather than a decision of members, it was the trustees or the SMSF who chose, for example, whether or not to engage external service providers. That would tend to show an inclination to equate the trustees with the SMSF rather than the members. Yet since all members are trustees it is disappointing that members were not more frequently brought into the description.

The recommendation of the Cooper Report to retain the trust framework is likely to carry weight for some time. The difficulties with its reasoning nonetheless also revitalised the need for further analysis on the suitability of the existing regulatory framework for the substance of the SMSF. The endorsement of a choice architecture for regulated superannuation highlights the precarious hold of the one-size-fits-all regulatory model, including the continued role of the trust framework. Despite the contribution of the Cooper Report, the recommendation to retain the trust framework due to the size, history, costs and challenges in replacing it is largely disconnected from its own guiding principles for SMSF regulation. Admittedly, basing the decision to retain the trust framework on those principles would have been difficult when they address the member, the SMSF and the trustee. Although weighting the trustee-related principles more heavily may have provided better justification, the challenge of how to overcome the first and second member-centric guiding principles seems difficult and may explain why that approach was not pursued.

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[31] Financial System Inquiry Committee, Commonwealth of Australia, *Financial System Inquiry Final Report* (1997).

[32] Refer Superannuation Review Panel, *Super System Review Final Report, Part One* (2010) 47-52.

While there is a willingness to recognise the important role of SMSF members, the difficulty for regulatory reform arises when moving from theory to application, given the competing principles surrounding the role of trustees. This reflects the limitation in the Cooper Report and is particularly evident when reference is made to the earlier Issues Paper. The features of the different superannuation fund models under the choice architecture were boldly set out and unimpeded by practical constraints, emphasising the self-directed, self-governed and compliance based approach to the SMSF:[33]

Diagram 2: Key features of fund models under choice architecture

	Disconnected	Universal	Choice	Self-Managed
Investment strategy	Conservative	Single strategy (incl. lifecycle)	Supermarket	Self-directed
Governance philosophy	Trustee-centric	Trustee-centric	Disclosure-based	Self
Ability to change option/fund	N/A	Less frequent	More frequent	N/A
Insurance	N/A	Death & TPD	Member decision	N/A
Reporting	-	Minimal	Comprehensive	Compliance based
Product Disclosure Statement	-	Streamlined perhaps on-line only	Comprehensive	N/A

At this preliminary stage the task was to characterise the substance of the different models, rather than being concerned with their legal framework, which may, or may not, reflect that substance. The ultimate decision to adopt a trustee-centric regulatory approach does not align with the importance placed on the self-direction and self-governance features of the SMSF model or with the compliance-based reporting approach. The disconnection shows why there is good reason for continued uneasiness and a basis for further enquiry to investigate how the substance of the SMSF might receive better recognition; specifically, beyond principle, how the substance of the arrangement could be more suitably accommodated within the trust framework. That issue is the subject of the remainder of this chapter.

33 Superannuation Review Panel, *Phase Three Structure Issues Paper* (2009) 3.

5.3 Accommodating substance – working with the trust framework

An incremental approach is adopted to consider how the existing trust framework can be improved to accommodate the SMSF substance. The first step begins with the recommendation of the Cooper Report that there is an insufficient case to abandon the trust framework. Although substance was an important consideration and did influence a number of the guiding principles for SMSF regulation, it proved insufficient to change the recommendation. Yet absent from the Cooper Report was any detailed analysis of the strong connection between fund assets and SMSF members within the endorsed trust framework. The strength of that connection is an important consideration to substantiate why, although retaining the trust framework, SMSF regulation should be capable of applying more directly to members, rather than through the veil of trusteeship.

Pursuing this approach, circumstances can be identified in trust law where the interest of a beneficiary in trust assets is proprietary in nature. Where the interest moves along the property continuum towards this point there may be a greater willingness to recognise the SMSF members' position and influence over trust assets, and so provide the focus of regulation. Furthermore, there is a range of statutory contexts where it is appropriate to develop the trust framework by examining the extent that individuals connected to a trust exercise control over and/or benefit from the trust. Where these features are sufficiently strong, the trust assets are dealt with for the identified purpose by placing less significance on trust law distinctions of ownership and greater emphasis on who *effectively* owns the property. It is instructive to consider whether these scenarios have application to the SMSF, given that members both benefit and exercise a high degree of control over fund assets. Where a connection can be made there may be grounds to limit the trustee-centric regulatory approach, notwithstanding the continued adoption of the trust framework. Regulation could then apply more directly to members, the trust framework retained and its suitability for the SMSF improved.

5.3.1 A trust law continuum of beneficial interests

Statutory considerations aside, the nature of a beneficiary's interest in trust assets and whether that connection is sufficient for those assets to be property of the beneficiary requires consideration of general trust law principles and the trust deed. Each particular case will fall to different points on a continuum reflecting a range of beneficiary interests. For that reason, reliance upon distinctions between categories of trust such as discretionary trusts or unit trusts is typically unhelpful, and erroneously assumes that those labels attract a constant, fixed normative meaning.[34] Even were attributes of a particular category easily identifiable, other features are all too often disregarded. For

34 Refer *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98, 109-110 (FC).

example, the description "unit trust" could suggest that a trust is a fixed trust, though closer inspection of its deed may reveal an element of discretionary entitlement inconsistent with that characterisation. Given the breadth of possible trust features, it is difficult to offer generic guidance on the relationship between trust assets and beneficiaries.

By reference to case law, a range of factors can be identified that tend to strengthen a beneficiary's interest in trust property along the continuum towards ownership, though traditionally falling short of that point. In particular, the nature of a beneficiary's interest frequently arises in trust-related duty cases, examining whether a disposal of trust property or changes in the range of eligible beneficiaries cause a change to beneficial ownership. The following analysis in *DKLR Holdings Co (No.2) Pty Ltd v Commissioner of Stamp Duties* (*DKLR*) is instructive by explaining the nature of a beneficiary's interest and its relationship to the holder of legal title:[35]

> After some hesitation, a trust interest in respect of land came to be regarded, not merely as some kind of equitable chose in action, conferring rights enforceable against the trustee, but as an interest in property. The fact that equitable estates were not enforceable against everyone acquiring a legal title to the property did not prevent them from being so regarded; a legal owner of land could lose his estate in, or become unable to enforce his rights in respect of, land in a number of ways. Although there has long been a controversy whether trust interests are true rights in rem ... there can be no doubt that the interest of the cestui que trust is an interest in property.

The statement is informative and cautionary. Not only it is unwise to force the nature of a beneficiary's interest into broad categories, there is also tension as to whether those interests reflect powers over property or are personal in nature. The distinction is addressed in *Jacobs' Law of Trusts*, explaining that for a trust to exist "… the trustee must be under a personal obligation to deal with the trust property for the benefit of the beneficiaries … The obligation attaches to the trustee *in personam*, but it is also annexed to the property, so that the equitable interest resembles a right *in rem*".[36] The qualification "resembles" identifies that while the beneficial interest is an interest in property, its essential character still bears the stamp which its equitable origins place upon it.[37] Accordingly, the trustee is the legal owner of the property and the right of the beneficiary, although annexed to that property, is a right to compel the legal owner to use the rights which the law gives them in accordance with the obligations imposed by equity.[38] The trustee has all the rights of the absolute owner, though due to the existence of the trust is constrained in how those rights may be exercised.

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35 [1980] 1 NSWLR 510, 518 (Hope JA). The statement by Hope JA was not affected by the subsequent appeal in *DKLR Holdings Co (No. 2) Proprietary Ltd v Commissioner of Stamp Duties (NSW)* (1982) 149 CLR 431.

36 Dyson Heydon and Mark Leeming, *Jacobs' Law of Trusts in* Australia (LexisNexis, 8th ed, 2016) [1-10].

37 *DKLR Holdings Co (No. 2) Pty Ltd v Commissioner of Stamp Duties* [1980] 1 NSWLR 510, 519 (Hope JA).

38 *DKLR Holdings Co (No. 2) Pty Ltd v Commissioner of Stamp Duties* [1980] 1 NSWLR 510, 519 (Hope JA).

Accepting these distinctions, the extent to which a trustee is limited in exercising his or her legal rights over trust property is useful to inform the content of a beneficiary's interest. At one extreme, there would be circumstances where a trustee holds property in trust absolutely for a beneficiary. In that case, the beneficiary has a right in equity to be put, so far as practicable and generally subject to appropriate indemnities being given, into a position, directly or indirectly or for all practical purposes, to enjoy or exercise the rights the law has vested in the trustee.[39] At the other extreme, the nature of a discretionary beneficiary's interest may be limited to no more than a mere expectancy,[40] with the trustee(s) having wide-ranging powers and significant discretion over how their legal rights are exercised. In both instances, beneficiaries have an interest annexed to the trust property, yet the precise content of that interest will vary, as will the extent to which the beneficiary can compel the trustee(s) to hold and use their legal rights.

One particular matter affecting beneficial interests in trust property is the trustee's right of indemnity. Subject to limitations in the trust deed and statutory qualification, a trustee is entitled as holder of the legal estate in trust property to reimbursement from that property for liabilities incurred in the proper administration of the trust. Even where a beneficiary has extensive rights to control how a trustee deals with trust assets, these will be qualified by the right of indemnity. Until satisfied, it remains impossible to identify the assets of the trust fund in which a beneficiary would have an interest. This impediment highlights the fact that beneficiaries entitlement to trust assets constituting the property to which they are entitled in equity is distinguishable from the underlying trust assets themselves.[41] That entitlement is limited to the assets remaining after the trust-related liabilities have been discharged or provision has been made for them. Until that occurs the relevant assets are not trust property in the sense of being held solely upon trusts imposing fiduciary duties that bind the trustee in favour of the beneficiaries.[42]

However, the significance of the trustee's right to indemnity is not without some uncertainty. In *Chief Commissioner of Stamp Duties v ISPT Pty Ltd*[43] (*ISPT*) Mason P suggested that the trustee's priority applied where termination of a trust was sought by all beneficiaries in accordance with the rule in *Saunders v Vautier*[44] (*Saunders*) for trust expenses actually incurred at that time. If correct, the trustees' right to indemnity would have a narrow operation. The High Court's decision in *CPT*

[39] *DKLR Holdings Co (No. 2) Pty Ltd v Commissioner of Stamp Duties* [1980] 1 NSWLR 510, 520.
[40] *Gartside v Inland Revenue Commissioners* [1968] AC 553, 607 (Lord Reid), 615 (Lord Wilberforce).
[41] *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226, 264.
[42] *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226, 264.
[43] (1998) 45 NSWLR 639, 653.
[44] *Saunders v Vautier* (1841) 4 Beav 115.

Custodian Pty Ltd v Commissioner of State Revenue[45] (*CPT*) supports a less restrictive approach. In deciding whether a sole beneficiary of a unit trust had rights to trust property amounting to equitable ownership, the High Court remarked as follows:

> In *Wharton v Masterman*, Lord Davey approached the rule in *Saunders v Vautier* from the viewpoint of the law respecting accumulations of income for an excessive period; if no person had any interest in the trust other than the legatee, the legatee might put an end to the accumulation which was exclusively for the benefit of that person and as a result there was no effective or enforceable direction for any accumulation. However, his Lordship's discussion of the authorities does indicate that the rule in *Saunders v Vautier* could not apply if, by reason of the charging of legacies on the fund and accumulations, the persons seeking to put an end to the accumulations were "only entitled to an undetermined and uncertain surplus (if any) which might be left of the fund after payment of the legacies".
>
> In the present case, the unsatisfied trustees' right of indemnity was expressed as an actual liability in each of the relevant accounts at each 31 December date and rendered applicable the sense of the above words of Lord Davey. Until satisfaction of rights of reimbursement or exoneration, it was impossible to say what the trust fund in question was.

The trustee's unsatisfied right to indemnity in *CPT* denied the unit holder's equitable interest in trust property from amounting to ownership, despite there being no attempt to invoke the rule in *Saunders*, nor any reasonable likelihood that the relevant unit holder would have been entitled to do so. That would suggest that the trustee's right to indemnity has broader significance than offered in *ISPT* and is not dependent upon an application to terminate the trust. Yet it is also important not to overstate matters and presume that a trustee holds some all-pervasive right to negate a beneficiary's equitable interest in the trust property in the absence of unreimbursed liabilities and without proper recourse to the deed. Furthermore, although the decision in *CPT* held that the unit holder's interest fell short of ownership, it did not examine or preclude unit holders from having some lesser proprietary interest.[46] The decision should be seen as endorsing the importance of context in trust law, and that the true nature of a beneficiary's interest in trust property requires detailed consideration of the particular terms of the trust and surrounding factual circumstances.

45 (2005) 224 CLR 98, 120-121 (footnotes omitted).

46 For example, the existence of a proprietary interest was identified in *Costa & Duppe Properties Pty Ltd v Duppe* [1986] VR 90, 96 (Brooking J); applying *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360. See further Richard White, 'The Nature of a Beneficiary's Equitable Interest in a Trust' (2007) NSWJSchol 12, [48].

Beyond these observations, it would be deficient not to make reference to the subsequent High Court majority decision in *Halloran v Minister Administering National Parks and Wildlife Act 1974*[47] (*Halloran*). *Halloran* involved an arrangement similar to that in *ISPT*, attempting to affect a transfer of beneficial interests in property without incurring duty.[48] In addressing whether there had been a change of beneficial ownership of the equitable interest in land held by Sealark upon exchange for A class units in the Pacinette trust, the majority resolved:[49]

> The answer must be that there had been a change. Consistently with the reasoning in *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)* and with the terms of the Pacinette trust deed, to which reference has been made earlier in these reasons, Sealark would not have any interest in any particular part of the trust fund or in any investment thereof.

The statement is consistent with *CPT*, in that despite being the sole A class unit holder, Sealark did not have an interest in the particular assets of the A fund. A difficulty with that conclusion follows from the absence of any facts to suggest that the trustee of the A fund had an unsatisfied right to indemnity. That was an important factor in the *CPT* decision and raises difficulty in finding the precise basis upon which the two cases are consistent. It is also unfortunate that *Halloran* did not address the earlier reasoning in *ISPT*, which held that the creation of a trust did not involve a change of beneficial ownership where a party owning land became the sole unit holder.[50] The lack of guidance on these points means that *Halloran* should be approached with some caution. Furthermore, while *Halloran* did hold that the unit holder in question lacked a proprietary interest in the assets of the Pacinette trust, it did not (nor did *CPT*) support any general principle that the holder of a unit in a unit trust lacks an equitable interest in trust property.[51] Whatever the reasons for its conclusion, given that *Halloran* is expressed to be consistent with *CPT*, it does not exclude the possibility that in appropriate contexts the beneficiary of a trust can demonstrate a proprietary interest in the assets of a trust. Seemingly, the question can only be resolved by reference to the particular terms of the trust.

Conclusion – equitable ownership

Drawing upon these observations, a SMSF member may well have some equitable proprietary interest in trust property based on the relevant deed and trust law principles. If that could be demonstrated, the positioning of SMSF members on the continuum of property interests may support a more direct

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[47] (2006) 229 CLR 545.

[48] Property was provided as consideration by Sealark Pty Ltd, who had an equitable interest in certain land, for the issue of A class units in the Pacinette Property Trust. The A units entitled their holder to a fractional interest in the corpus of the A fund. Later, the A class units were then redeemed leaving the property on trust for ordinary class unit holders.

[49] (2006) 229 CLR 545, 570.

[50] Perhaps that was unnecessary as *ISPT* was decided before *CPT*.

[51] *CPT Manager Ltd v Chief Commissioner of State Revenue* (2006) 64 ATR 654, [50] (Gzell J).

application of regulation to those members, rather than the existing trustee focus. On that basis, notwithstanding the adopted trust framework, regulation would better align with the substance of the SMSF. The key attraction of the SMSF, to give members a high degree of control over all aspects of fund decision-making, supports a strong case for member interests to fall closer to the ownership end of the property continuum. Yet to reach that position the nature of a member's interest in SMSF assets must be properly analysed by reference to the SMSFs trust deed and restrictions in the SISA.

In this regard, it is relatively clear that SMSF members have significant rights to compel trustee adherence to the terms of the trust, particularly as all members are also trustees or directors of the trustee company. In the case of single member SMSFs, the case is particularly strong, since the member compels themselves to act in accordance with the deed and their own instruction. However, even this high degree of control remains subject to limitations. Beyond any unsatisfied right of indemnity, the SISA imposes significant restrictions, including that unless members have reached vesting age or a condition of release they will be prevented from calling on the trust assets. To that extent, the SMSF trust may create only future beneficial interests. Even assuming release conditions have been satisfied, there are further limitations to accessing assets from the trust, such as restrictions on in-specie transfers and withdrawal conditions for complying income streams. Accordingly, despite having significant control and some equitable interest in SMSF assets, it is difficult to accept that the position of the SMSF member interest equates to equitable ownership. Although not necessarily taking into account the peculiarities of the SMSF, this conclusion is consistent with more general views on the nature of a member's interest in regulated superannuation.[52] Given these difficulties, it is appropriate to consider whether the substance of the arrangement can be recognised on another basis.

5.3.2 Statutory approaches to trust property

A number of instances can be identified where statute has intervened to develop its own criteria to attribute trust property to beneficiaries or other connected entities. Within each statutory context, it is then possible to treat persons as having property in the assets of a trust or otherwise take such property into account when addressing their position for a particular legislative purpose.
This has largely been achieved using control and benefit related concepts as a proxy test to aggregate trust assets with its beneficiaries or other connected entities. In some instances, this has also been supported by an expansive definition of property itself. By adopting these approaches policy makers have ensured that the intent of statutory measures is not frustrated by trust law distinctions regarding

[52] Gino Dal Pont, 'Key Australian Decisions in 2004 – Trustee Accountability for Discretionary Decision Making' (Paper presented at Superannuation 2005: Devil is in the Detail, Hobart, 24 February 2005); Graham Hill, 'The True Nature of a Member's interest in a superannuation fund' (2002) 5(1) *Journal of Australian Taxation* 1.

property ownership. Yet, with some exception, case authority has also been careful to avoid creating inconsistency with trust law by emphasising the particular statutory context in question. The control and benefit approach may be particularly suitable for the SMSF, given that members have a high degree of control over all decision making processes and, at least for their lifetime, are the only individuals to benefit from the fund.

The significance of the control and benefit approach is illustrated through its application to the discretionary trust, whose beneficiaries might be expected to fall towards the lower point on a continuum of property in trust assets (though as previously emphasised, care must be taken not to rely heavily on broad trust descriptions when examining the position of beneficiaries, including generalisations that a trust is discretionary). At one extreme, a discretionary trust may have completely independent trustees, where a mere object of the trust does not have a proprietary interest in any particular asset of the trust or in the trust fund as a whole. In such a case, the trust deed would typically give the trustee very wide powers, enabling them to determine whether an individual beneficiary is to benefit at all, and in that sense the beneficiary has nothing more than a mere expectancy.[53] However, the scenario of a discretionary trust with completely independent trustees does not align to the substance of the SMSF whose members are also trustees or trustee-directors.

To ensure that trust-related control and benefit principles are relevant for application to the SMSF, it is appropriate to consider the position of a modern discretionary trust used for family or business purposes. In particular, that type of trust would have trustees that are not independent or are otherwise liable to be removed by the appointor if their decisions are inconsistent with the wishes of the real controller. In those circumstances, the substance of the arrangement does not easily align with the trust law framework and is similar to the position of the SMSF. The ability of the beneficiaries or other relevant persons to control and benefit from this type of trust provides a context where statute is more willing to intervene and address its substance, rather than adhere to strict trust law distinctions of property ownership.

5.3.2.1 Receivership – Corporations Act 2001

Part 5.2 of the *Corporations Act 2001* (Cth) (CA) addressing receivership and its supporting case law show a willingness to develop trust law principles concerning ownership of trust property. For this purpose, the word property is defined to mean "any legal or equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description and includes a thing in action".[54] While that definition is particularly broad, trust-related receivership case

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53 *Gartside v Inland Revenue Commissioners* [1968] AC 553, 607 (Lord Reid), 615 (Lord Wilberforce).
54 *Corporations Act 2001* (Cth) s 9 (definition of "property").

law has been forced to clarify its application to discretionary trusts having less than independent trustees. *ASIC v Carey (No 6)*[55] (*Richstar*) addressed this issue when considering whether, for the purposes of appointing receivers under s 1323 of the CA, a beneficiary of a discretionary trust had a contingent equitable interest in trust property.

The decision in *Richstar* supports the need to distinguish between discretionary trusts with completely arm's length trustees and those having a less independent character. In relation to the former, French J was "inclined to think that a beneficiary in such a case, at arm's length from the trustee, does not have a "contingent interest" but rather an expectancy or mere possibility of a distribution".[56] Such a beneficiary would not have an equitable interest in the trust property for the purposes of s 1323 of the CA. However, as the facts in *Richstar* revealed, the matter becomes more complicated when the degree of trustee independence is removed. Where the beneficiary of a discretionary trust controls the trustee, French J was guided by an earlier decision of *FCT v Vegners*[57] where Gummow J, who described the nature of a discretionary trustee's power as "a general power and thus would be tantamount to ownership of the property concerned". French J resolved:[58]

> At least by analogy it may be observed that a beneficiary who effectively controls the trustee of a discretionary trust may have what approaches a general power and thus a proprietary interest in the income and corpus of the trust.

His Honour continued:[59]

> … where a discretionary trust is controlled by a trustee who is in truth the alter ego of a beneficiary, then at the very least a contingent interest may be identified because, to use the words of Nourse J, "it is as good as certain" that the beneficiary will receive the benefits of distributions either of income or capital or both.

Three of the trusts under consideration in *Richstar* met these descriptions, with the relevant beneficiary having sufficient control so that the trust assets were treated as their property. On that basis, French J proceeded to make orders appointing receivers to the trust assets. In each instance the beneficiary had at least a contingent interest within the meaning of the word "property" as defined in s 9 of the CA. In the first trust the beneficiary was a director of the corporate trustee and their first and then second wife was the appointor.[60] In the second trust the beneficiary was the trustee and their wife

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55 (2006) 153 FCR 509.
56 (2006) 153 FCR 509, 520.
57 *FCT v Vegners* (1989) 90 ALR 547, 552.
58 (2006) 153 FCR 509, 516.
59 (2006) 153 FCR 509, 520.
60 (2006) 153 FCR 509, 521.

was the appointor.[61] In the third trust the beneficiary was also the appointor.[62] The first and second trusts particularly illustrate the point that while there must be a high degree of control over the trust it need not necessarily be absolute. Although the relevant beneficiary would require the assistance of his wife as appointor, the reality of the situation was that her cooperation would reasonably be expected.

However, the full implications of *Richstar* are not entirely clear given the subsequent receivership case of *ASIC v Burnard*[63] (*Burnard*) arising from the failed Westpoint Group of companies. Once again, the definition of "property" in s 9 of the CA was considered to determine whether the assets of two discretionary trusts were property of an individual. While the enquiry essentially considered the same issue addressed by French J in *Richstar*, the decision in *Burnard* was particularly concerned with the interests of other persons in the trust property. Barrett J held that the relevant individual did not have an exclusive entitlement to the trust assets, given that the trustee had a right to exoneration and therefore a beneficial interest in those assets. That conclusion is consistent with the trust law principles of trustee indemnification canvassed earlier and was strongly influenced by the decision in *CPT*. The decision of French J in *Richstar* was distinguished, albeit rather finely, by reference to the nature of the orders sought and standing of the relevant person. Barrett J explained:[64]

> The case before French J was not one in which an order directed to someone other than a "relevant person" was sought. Rather, the court was asked, in effect, to determine that certain items of property were "property of" the "relevant person" and to recast the existing order affecting the relevant person's property generally so as to refer to the particular items. The analysis was directed towards the existence and nature of the separate interest a person might have because standing in a particular relationship to a trustee or trust property – whether because included in a class or persons who might be selected to benefit under a discretionary trust, or because a member of a superannuation scheme established as a trust, or because occupying under a trust instrument a position of "guardian" or "appointor" involving some power to alter the composition of classes of discretionary objects or to participate in decision-making with respect to allocation of benefits.

He continued:[65]

> … I cannot find that the whole of the assets of BDI, including the whole of the assets of each of the three trusts, is "property of" Mr Burnard. It may be that he has an equitable interest of a proprietary kind in the assets of each trust, according to one or more of the approaches explored by French J in Carey (No 6) (above). That is not something that the present application requires me to decide. Any

61 (2006) 153 FCR 509, 522.
62 (2006) 153 FCR 509, 522.
63 (2007) 64 ACSR 360.
64 (2007) 64 ACSR 360, [70].
65 (2007) 64 ACSR 360, [78].

> such interest would be susceptible to being dealt with as "property of" Mr Burnard and will be caught by O 1 accordingly, if that order is made. But the subsistence in the assets as a whole of beneficial interests other than any interest that Mr Burnard may have means that it is not open to the court to make O 3, being an order directed to BDI.

Therefore, while in substance *CPT* and *Burnard* sought the appointment of receivers to property held in trust, the nature of the orders sought apparently revealed a material difference. According to *Burnard* an order that the whole of the trust assets were property of the relevant individual faced an insurmountable hurdle, requiring there to be no other interests in the whole of those assets held by the trustee or other persons.[66] The decision did not exclude the individual concerned from having a proprietary interest in the whole of the assets of the trust sufficient in its own right to constitute property of that individual.[67] However, the existence of other interests meant that the whole of the trust assets was not property of the individual, nor could they be regarded as consisting of that individual's proprietary interest together with the other interests subsisting in those assets.[68] It would seem that *Richstar* should be applied cautiously and, although French J did not do so, with some regard to the principles in *CPT* and the need to examine the terms of the particular trust deed. Subject to that consideration, the control-type analysis applied by French J in *Richstar* continues to provide one avenue to approach trust assets as being property of another for CA purposes.

Conclusion – receivership

The receivership context reveals some willingness when addressing non-independent trustee type discretionary trusts to draw a connection between a relevant beneficiary and the location of control. Where a trustee is effectively the alter ego of the beneficiary or otherwise subject to their control, a connection may be made to determine that the beneficiary has an interest in the trust assets amounting to property. Disregarding the specific rules applicable to superannuation under the CA,[69] as a matter of principle the importance placed the control holds promise for a member's interest in SMSF assets also amounting to property. However, the significance of the receivership approach should not be overstated, given that while a beneficiary's interest may amount to property as defined in s 9 of the CA, the strength of their interest may still fall towards the lower end of the property continuum. That conclusion is supported by the way that French J explained the interest as at least a contingent interest, though unwilling to elaborate to any higher degree.

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66 (2007) 64 ACSR 360, [67] (Barrett J).
67 (2007) 64 ACSR 360, [68] (Barrett J).
68 (2007) 64 ACSR 360, [68] (Barrett J).
69 The *Corporations Act 2001* (Cth) regulates the conduct and disclosure obligations of financial services providers (including superannuation trustees) that hold an Australian financial services licence.

Subsequent case law has emphasised that French J in *Richstar* was concerned with the content and extent of a contingent interest for the purposes of s 9 of the CA, rather than doubting trust law principles surrounding the nature of a beneficiary's interest in discretionary trust assets.[70] It would therefore be an over-reach to ignore the detail of the decision to broadly conclude that a requisite degree of control will make the object of a discretionary trust the beneficial owner of the trust property. Yet the specific SMSF regulatory context does not require such a generalisation. The unique features of the SMSF, particularly the control exercised by members who are also trustees or directors of the corporate trustee, may present a specific case for a member's interest in trust property to be recognised in a similar way to the receivership context. That would provide a basis to justify a more direct regulatory approach to members reflecting the substance of the SMSF, with less concern for the trust framework and incidents of trusteeship.

5.3.2.2 Family law – Family Law Act 1975

The Family Court of Australia's (Family Court) approach to property division between parties to a marriage illustrates further circumstances that develop trust law principles concerning the ownership of trust property.[71] The guidance arises from s 79 of the *Family Law Act 1975* (Cth) (FLA), which empowers the making of orders relating to the settlement of property between the parties to a marriage. Before making any orders the Family Court will embark on a four-step process,[72] the first part of which is commonly referred to as determining the asset pool.[73] That will involve an examination of the assets and liabilities of the parties to a marriage, so as to determine whether assets are property that in whole or part should be treated as property of the marriage, a financial resource, or neither property nor a financial resource. For this purpose, property is defined to mean "property to which those parties are, or that party is, as the case may be, entitled, whether in possession or reversion".[74] In contrast, a "financial resource" is a much broader and undefined expression. It has been held to include the benefit of a source of financial support owned by a third party and which a party can reasonably expect would be available to him or her to supply a financial need or deficiency.[75]

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70 *Kawasaki (Australia) Pty Ltd v Arc Strang Pty Ltd* (2008) 247 ALR 333, [75] (Goldberg J).

71 Although the *Family Law Act 1975* (Cth) also applies to de facto relationships, for expediency the discussion uses the expression "parties to the marriage".

72 *In the Marriage of Hickey* (2003) 30 Fam LR 355, 370 (Nicholson CJ, Ellis and O'Ryan JJ); *Stephens v Stephens and J* [2005] FamCA 1181, [105] (Strickland J).

73 Refer *Spoke v Spoke (No. 2)* [2009] FamCA 40, [151]-[152] (Cronin J); Kennon v Spry (2008) 238 CLR 366, 405, 409 (Gummow and Hayne JJ).

74 *Family Law Act 1975* (Cth) s 4(a).

75 *In the Marriage of Kelly (No 2)* (1981) 7 Fam LR 762.

Provided that the order is just and equitable, s 79 of the FLA gives the Family Court a broad discretion to alter the property interests of the parties to the marriage or to make orders for settlement of property in substitution for any interest in property. However, while the discretion is broad, the ability to make an order is constrained by the need to identify "property" of the parties to the marriage or either of them.[76] A financial resource cannot be the subject of an order, though its presence may influence the content of an order that can properly be made.[77] Accordingly, finding that the ability to benefit from a trust is a financial resource may support a similar outcome to where trust assets are found to be property of the parties.[78] That approach would avoid complexities surrounding the relationship between trust assets and the parties to the marriage, though it does not assist the present enquiry. The matter under consideration is the circumstances in which s 79 of the FLA designates trust assets to be property of the parties to the marriage. The instances where this occurs may support a similar statutory approach to be adopted to justify a more direct regulatory approach to members reflecting the SMSF substance, rather than the existing trustee focus.

Control and benefit – trust assets as de facto property

When resolving property settlement matters the Family Court is not legislatively empowered to disregard the existence of the trust framework.[79] Therefore having reference to trust law principles, the starting position is that an asset held on trust is not property of a party to the marriage. The trustee is the legal owner of the trust property, annexed to which is a personal obligation to deal with that property for the benefit of the beneficiaries. Although the interest of beneficiaries in trust assets will fall somewhere along a property continuum, the preceding discussion has indicated its positioning will typically fall short of ownership. To overcome this obstacle, the Family Court has demonstrated a willingness in appropriate circumstances to develop trust law distinctions concerning property ownership. With some similarity to the analysis pursued by French J in *Richstar*, a control and benefit approach is adopted to determine whether trust assets are property of the parties to the marriage.

When examining the significance of trust assets in property settlement proceedings, the Family Court determines whether one or both of the parties to the marriage can control and benefit from a trust's

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76 *Barker v Barker* (2007) 36 Fam LR 650.

77 *Family Law Act 1975* (Cth) s 79(4)(d) requires an order under s 79 to consider the matters in s 75(2) addressing spousal maintenance. Particular items for consideration under *Family Law Act 1975* (Cth) s 75(2)(b) include "the income, property and financial resources of each of the parties".

78 *Stephens v Stephens (enforcement)* (2009) 42 Fam LR 423, [68] (May, Boland and O'Ryan JJ).

79 The Family Court must take the property of the party to the marriage as it finds it and cannot ignore the interests of third parties, nor conditions or covenants that limit the rights of the party who owns it: *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337, 355 (Gibbs J).

assets.[80] Where such circumstances exist, those assets are likely to be included in the pool of assets for division, notwithstanding the potential inconsistency that they are not considered property of either party under trust law. The case for statutory intervention to ensure a different result is grounded on principles of justice and equity. It would be inconsistent with those principles if trust assets could be quarantined from the property settlement, yet a spouse maintain the power to determine at any point in time where the income and/or capital of the trust is be distributed, including to themselves.[81]

The case of *In the Marriage of Ashton*[82] (*Ashton*) illustrates these principles, involving a discretionary trust whose appointor, original trustee and shareholder in the subsequent corporate trustee was the husband. The objects included the wife and entities associated with the husband, the latter meaning that while the husband was not a named beneficiary there was in practice nothing to prevent him from receiving the full benefit of the trust.[83] The Full Family Court confirmed that the trust assets should be included in the pool of assets for division by using a control and benefit approach. Having regard to what had happened, the husband's power of appointment and the attributes which it carried, there was "de facto ownership" of the property of the trust for the purposes of s 79 of the FLA.[84] It was held that "in a family situation such as the one here, this court is not bound by the formalities designed to obtain advantages and protection for the husband who stands in reality in the position of the owner. He has de facto legal and beneficial ownership".[85] The expressions "de facto" and "in reality" preface the basis upon which the trust assets were considered property of the husband, the particular context for which that conclusion was drawn and therefore the ability to co-exist with the existence of a valid trust.

The subsequent case of *In the Marriage of Davidson*[86] (*Davidson*) similarly adopted a control and benefit approach in dealing with the assets of a discretionary trust. The husband was the appointor and director of the corporate trustee. The wife was an object of the trust, though gave trust distributions back to the husband. Although the husband was ineligible to be a beneficiary, he could cause the trustee company to apply the capital of the trust for the benefit of a company in which he was a shareholder, so long as a beneficiary was also a shareholder.[87] The control and benefit approach justified the trust assets being included in the pool of assets for division. In dismissing the husband's appeal, claiming that he would be forced to access trust assets even though he was not a beneficiary,

80 For example, *In the Marriage Davidson* (1990) 14 Fam LR 817, 824 (Simpson, Nygh and Murray JJ); *In the Marriage Ashton* (1986) 11 Fam LR 457, 461-462 (Ellis, Emery and Strauss JJ).
81 *Beeson v Spence* [2007] FamCA 200, [31] (Moore J).
82 (1986) 11 Fam LR 457.
83 (1986) 11 Fam LR 457, 462.
84 (1986) 11 Fam LR 457, 462.
85 (1986) 11 Fam LR 457, 463.
86 (1990) 14 Fam LR 817.
87 (1990) 14 Fam LR 817, 824.

the Full Family Court endorsed its decision in *Ashton*. It identified that "Australian Courts today have to look at the reality of the situation and the purpose which family trusts serve today".[88] After observing that no person other than the husband had any real interest in the property or income of the trust, it concluded "he has the de facto ownership of the trust property. We are of this view notwithstanding the existence of a valid trust".[89] Once again, the expression "de facto" prefaces the basis upon which the trust assets were considered property of the husband, rather than for all purposes.

Control and benefit – the power to add trust assets to the pool

The control and benefit approach to trust assets in property settlement proceedings has continued to evolve from these straightforward applications. One such example is *Stephens v Stephens and J*[90] (*Stephens*), a case that, amongst other matters, concerned whether trust assets should be included in the pool of assets for division. The husband was the trustee of a discretionary trust (Trust), though was not a beneficiary. Prior to separation from his wife the husband excluded the wife as a beneficiary of the Trust. After separation, but before divorce, the husband set up and was the trustee of four discretionary trusts for his children. Before retiring as trustee of the Trust, the husband caused significant capital and income to be distributed to these discretionary trusts.

At first instance, Strickland J resolved that the husband could have applied the whole or part of the Trust assets for his own benefit.[91] Presumably that was on the basis he could reinstate himself as a beneficiary and to that extent the decision to include the assets of the Trust in the pool of assets for division was consistent with the basic control and benefit approach applied in *Ashton* and *Davidson*. However, reservations emerge because of the way that the trust assets were characterised, proceeding on the basis that they were or could be the husband's property. In comparison to the earlier approaches that preface trust assets as "de facto property" to emphasise the proper context to the conclusion, Strickland J found that "the assets of the Trust can be treated as his property once the relevant instruments and dispositions are set aside, and thus that is a source of funds for the husband".[92] This may suggest that the Trust's assets were property of the husband for broader purposes. It is also possible that, since the discussion of trust assets was self-evidently for the purpose of asset pooling, it was unnecessary to continually qualify the word "property" so as to avoid explanations being taken out of context.

[88] (1990) 14 Fam LR 817, 824.
[89] (1990) 14 Fam LR 817, 824.
[90] [2005] FamCA 1181.
[91] [2005] FamCA 1181, [129.4.32].
[92] [2005] FamCA 1181, [268].

The matter in *Stephens* eventually appeared before the High Court in *Kennon v Spry*[93] (*Spry*) to produce authority extending the basic control and benefit approach. The difficulties in reconciling family and trust law principles concerning the existence of trust assets and their connection to the parties to the marriage appears to be reflected in need for four separate judgments. Importantly, the majority did not adopt the approach of the trial judge that the Trust assets were property of the husband once the instruments and dispositions were set aside. French CJ resolved that it was inconclusive of the outcome whether the husband could have applied the assets for his own benefit.[94] Instead, his enquiry focussed on the statutory expression "property of the parties to the marriage". French CJ explained that assets do not necessarily escape that expression where a party has declared a trust over them, as a trustee can, under the terms of that trust, give the property away to other family members at their discretion.[95] Gummow and Hayne JJ agreed that if the husband was unable to be reinstated as a beneficiary, that would only deny he had property in the assets of the Trust and would not prevent the assets being "property of the parties to the marriage".[96] The implication from both explanations is that while the husband may or may not have property in the Trust assets through a trust law analysis, that type of enquiry was not determinative since the relevant expression was "property of the parties to the marriage".

The majority decision in *Spry* held that the Trust assets were property of the parties to the marriage for the purpose of s 79 of the FLA due to the legal ownership of the assets by the husband as sole trustee and the wife's interest as a beneficiary.[97] French CJ held that "it is the Trust assets, coupled with the trustee's power, prior to the 1998 Instrument, to appoint them to her and her equitable right to due consideration, that should be regarded as the relevant property".[98] Gummow and Hayne JJ held that "the property of the parties to the marriage or either of them was to be identified as including the right of the wife to due administration of the Trust, accompanied by the fiduciary duty of the husband, as trustee, to consider whether and in what way the power should be exercised".[99] Although the statements are not identical, they support a principle, in the context of family law property settlement, that the assets of a discretionary trust can be treated as property of the parties to the marriage where a spouse can exercise powers to cause those assets to become property of one *or other* of the spouses.[100]

93 *Kennon v Spry* (2008) 238 CLR 366; appeal heard from *Stephens v Stephens* (2007) 38 Fam LR 149.
94 (2008) 238 CLR 366, [71] (French CJ); [126] (Gummow and Hayne JJ).
95 (2008) 238 CLR 366, [65] (French CJ).
96 (2008) 238 CLR 366, [126] (Gummow and Hayne JJ).
97 Unlike French CJ, Gummow and Hayne JJ, Kiefel J dismissed the appeal by reference to *Family Law Act 1975* (Cth) s 85A.
98 (2008) 238 CLR 366, [62].
99 (2008) 238 CLR 366, [137].
100 Paul Brereton, 'The High Court and Family Law – Two Recent Excursions' (Paper presented at the Family Court and Federal Magistrates Court Concurrent Conference, Canberra, 16 October 2010) 17-18.

Although *Spry* extends the basic control and benefit approach from where the controller is also a beneficiary, it is still based on consistent principles. Trust assets are aggregated because the spouse with effective control as trustee or appointor is able to choose whether to procure the trust assets, for their own benefit or for their spouse, and bring them into the pool of assets for distribution. To permit trust assets in those circumstances to escape from being property of the parties to the marriage would be contrary to notions of justice and equity that guide family law principles. Where trust assets are included in the pool of assets for division as property of the parties to the marriage, they are so characterised for the context of the FLA. Accordingly, the Family Court cannot simply deal with trust property as it sees fit.[101] Consistently, French CJ in *Spry* identified the need to ensure that any further consequences of trust assets being property of the parties to the marriage were consistent with trust law.[102] His Honour held that the application of the Trust assets to the wife would be consistent with the proper exercise of the husbands powers as trustee,[103] while Gummow and Hayne JJ helpfully observed that if the husband sought to satisfy his obligations by recourse to the Trust assets he could approach the Court for an appropriate order.[104] The subsequent proceedings in *Stephens v Stephens (enforcement)*[105] also addressed this issue in holding that the application of the Trust assets in favour of the wife was consistent with the proper exercise of the husband's powers as trustee and involved no breach of duty to other beneficiaries.

Although the orders in *Spry* did not rely on Part VIIIAA of the FLA, given that the husband was the owner of the Trust assets as trustee, that Part has further significance for trust assets subject to property settlement proceedings. In particular, s 90AE empowers the Family Court to make orders under s 79 binding on a third party. Accordingly, an order based on trust assets being property of the parties to the marriage is enforceable against third parties, even though they may not otherwise recognise the parties to the marriage as having property in those assets. In *Simmons v Simmons*[106] (*Simmons*) Watt J addressed the effect of the Part, after citing the principles in *Spry*, in holding that the husband's right to due administration as a trust object was property for the purposes of the FLA and Part VIIIAA of that Act could apply to that interest.[107] This further statutory intervention may result in some additional rebalancing between trust and family law principles, increasing the ambit of the decision that trust assets are property of the parties to the marriage, to the extent that Pt VIIIA of the FLA underpins an order.

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101 *BP v KS* (2002) 31 Fam LR 436, [81] (Warnick J).
102 (2008) 238 CLR 366, [80].
103 (2008) 238 CLR 366, [67].
104 (2008) 238 CLR 366, [138].
105 (2009) 42 Fam LR 423, [115], [345], [351]-[353] (FC).
106 (2008) 40 Fam LR 520.
107 (2008) 40 Fam LR 520, [122]-[123].

Conclusion – family law

Adding to the guidance identified from the receivership context, family law has embraced a control and benefit approach to connect a husband or wife to the assets of a trust for the purpose of property settlement. As a matter of broad principle, the importance placed on control and benefit when addressing trust assets holds promise for the SMSF.[108] In the case of a single member SMSF the approach is particularly suitable, since not only does the member control the assets but is also the only person, whilst they are living, to benefit. Where SMSF membership increases the control is necessarily shared, but it still remains high, particularly where those members are also family members or close associates. Consideration of the family law approach also demonstrates that it is unnecessary for absolute control and benefit to vest in one particular party. By applying these principles and looking at the substance of the arrangement, there is a strong case that SMSF assets should be treated as "property of the parties to the SMSF". That conclusion is not necessarily inconsistent with trust law principles as it would extend only for the specific purpose of SMSF regulation.

Given that the FLA contains specific rules applicable to regulated superannuation, it is accepted that the control and benefit approach to the SMSF trust is of theoretical application. Nonetheless, the Family Court continues to grapple with how SMSF assets should be dealt with in property settlement matters. Consistent with the substance of the arrangement, there is some propensity to treat superannuation as an ordinary investment by the parties, rather than one occurring within a regulated trust framework. At times this has led the Family Court to place excessive weight on the investment acumen of a particular spouse,[109] failure to clarify that investment acumen of a spouse is applied in a trustee capacity[110] and to issue of s 79 orders affecting transfers of assets to an SMSF without regard to restrictions in the SISA that prevent such action.[111] These examples probably reflect a failure to understand the SISA regulatory framework, yet also show a willingness to accept the SMSF context differs from other regulated superannuation.

5.3.2.3 Tax law – Income Tax Assessments Acts 1936 and 1997

Development of trust law principles also arises in the *Income Tax Assessment Act 1936* (Cth) (ITAA1936) and *Income Tax Assessment Act 1997* (Cth) (ITAA1997) through the connection of trust property, beneficiaries and other related entities. However, unlike family law and receivership, the

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108 Putting aside the rules contained in the FLA Pt VIIIB that specifically deal with superannuation splitting.
109 *Kane v Kane* [2011] FamCA 480, [124]-[141] (Austin J).
110 *Kane v Kane* (2013) 50 Fam LR 498, [23] (Faulks DCJ), [110] (May and Johnston JJ).
111 *Pera v Pera* (2008) 39 Fam LR 469, [54] (Coleman, May and Boland JJ).

word "property" is not supported by statutory definition. While that may indicate taxation law has declined to develop general law principles of property ownership, it more accurately reflects the subordinate role that the word property plays in taxation. For taxation purposes the critical task is to resolve the questions of who to tax, what to tax and how much to tax. When addressing these matters, including for the trust context, taxation law has tailored its own legislative rules and principles. Those rules are extremely varied and may adopt, extend or ignore trust law principles, provide discretion to proceed as if those principles were satisfied, and contain deeming mechanisms to ignore ownership of property in law or equity.[112] Even where a taxing provision may contain the word property, its inclusion will typically lack any controlling influence over whether a section applies.[113]

Rather than focus on the word property, trust-related taxation provisions have adopted a range of terms to inform the question of who to tax, such as beneficial ownership, equitable interest and absolute entitlement. These are supplemented with statutory concepts that are completely unrelated to property, such as present entitlement and specific entitlement. The question of what to tax is not trust property but the net income of the trust, broadly the assessable income of the trust, less allowable deductions and prior year losses that are available for utilisation.[114] That formulation goes beyond income derived from the application or realisation of property, and its elements are extrapolated in detailed provisions throughout the Acts and through general law revenue principles. The amount of tax to be paid on net income is also not resolved by whether or not beneficiaries have property in trust income. Division 6 of the ITAA1936 substantively determines the tax liabilities of a trustee and/or the trust beneficiaries, based on the existence or otherwise of a present or specific entitlement to the net income of the trust estate, combined with Subdivisions 115-C and 207-B of the ITAA1997 applying to assess capital gains and franked distributions.

Given that tax law employs a mix of words, sometimes a statutory invention and sometimes corresponding to the general law, combined with a revenue objective that goes beyond taxation of property, it is difficult to generalise how trust law principles have been developed for this context. However, a statutory connection between a trust and taxpayers who control or benefit from its assets frequently arises as an important determinant to how taxing provisions are applied. Similar to the receivership and family law contexts, for a number of taxation purposes an important task is to

112 See Tim Galvin and Damien Lockie, 'Ownership – update of foundational principles for revenue laws' (2006) 9(5) *The Tax Specialist* 271.

113 For example, the capital gains tax regime in ITAA1997 Part 3-1 to 3-3 which is commonly associated with taxation of property disposals, is in fact triggered by a "CGT event" occurring in relation to a "CGT asset". ITAA1997 s 108-5(1)(a), (b) (definition of "CGT asset") defines a CGT asset very broadly as "any kind of property; or a legal or equitable right that is not property". ITAA1997 Division 104 sets out all the CGT events from which you can make a capital gain or capital loss, including a range of transactions that may or may not constitute a disposal of legal or equitable interests, such as the creation of rights in others.

114 ITAA1936 s 95.

aggregate trust assets with those of a beneficiary or other entity that can be connected to the trust. In doing so, the revenue objective shows a preparedness to develop trust law distinctions through statutory rules that address the substance or economic ownership of the arrangement. In light of the important role that taxation concessions play to encourage participation in the SMSF sector, consideration of the taxation approach provides useful guidance for the development of regulation that reflects the SMSF substance.

The trust as a connected entity

A common way that a beneficiary is connected to the assets of a trust for taxation purposes is through the "connected with" rules in Division 328 of the ITAA1997.[115] The broad principle is that an entity is connected with another entity where either entity controls the other or both entities are controlled by the same third entity.[116] A prerequisite for this requirement to apply is that the word "entity" includes a trust, and so begins the development of trust law principles through statutory definition.[117] Defining an entity to include a trust meets the practical need to identify a trust as an object or thing to which taxation rules can apply, although sits awkwardly with a trust law view that it is a relationship.[118] However, despite seeming to lack appreciation for the separate roles of trustee, trust property and beneficiaries, this inconsistency does not render the trust-related taxation provisions of the ITAA1997 or ITAA1936 unworkable. While defining a trust as an entity may be at odds with trust law, it does not defeat the operation of the Acts, nor prevent a court from giving effect to legislative intent. The existence of the trust is accepted as a matter of general law, yet in pursuing its revenue objectives taxation law legitimately proceeds on the basis of assumptions that are otherwise fictitious.

A key aspect of the "connected with" test is that it is primarily concerned with control or benefit rather than strict ownership distinctions. To establish control of a trust, different rules apply depending on whether or not the trust is a discretionary trust, though that expression is not specifically

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115 A frequent purpose for establishing control of a trust is to determine whether the trust or its controller can access small business relief under ITAA1997 Division 152. A basic condition to access those concessions under ITAA1997 s 152-10(1)(c)(i) is that the entity is a small business entity for the income year. For this purpose, ITAA1997 ss 328-115 aggregates the annual turnover of other connected entities with the turnover of the claiming entity for the purpose of determining whether the total exceeds a threshold of $2 million. An alternative basic condition under ITAA1997 s 152-10(1)(c)(ii) is that the net value of the claiming entity's assets, aggregated with those of its connected entities do not exceed a maximum net asset value threshold of $6 million. ITAA1997 s 328-125 contains the meaning of *connected with* an entity for purpose of both basic conditions.

116 ITAA1997 s 328-125(1).

117 ITAA1997 s 960-100(1)(f) (definition of "entity") means "a trust". The explanatory note accompanying the definition states that the word entity "covers groups of legal persons, and other things, that in practice are treated as having a separate identity in the same way as a legal person does". Yet, that is not particularly appropriate for a trust, whose existence is grounded on a particular relationship between property and the parties involved. The relationship is not simply a "group of legal persons" and is also not described well as an "other thing".

118 Tony Slater, 'Unit trusts: Law and Lore' (2006) 35 *Australian Tax Review* 185, 187.

defined, nor as previously indicated does it have any fixed meaning at general law.[119] It appears that the intention in using the term "discretionary" was to distinguish the positon of a fixed trust, where persons have fixed entitlements to all of the income and capital of the trust, and a non-fixed trust where this is not the case. That approach is adopted in other parts of the Division, such as when determining an entity's small business participation percentage.[120] For that purpose, there is no legislative discretion to treat a non-fixed trust as a fixed trust,[121] though unlike the decision in *CPT* it may be that a trustee's right to indemnity assumes less importance.[122] Depending on the type of trust in question, the following legislative pathways in the ITAA1997 may be used to establish control of a trust:

Direct control of an entity other than a discretionary trust

328-125(2) An entity (the first entity) controls another entity if the first entity, its affiliates, or the first entity together with its affiliates:

(a) except if the other entity is a discretionary trust – own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the control percentage) that is at least 40% of:
   (i) any distribution of income of the other entity; or
   (ii) if the other entity is a partnership – the net income of the partnership; or
   (iii) any distribution of capital by the other entity; or

Direct control of a discretionary trust

328-125(3) An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its affiliates, or the first entity together with its affiliates.

328-125(4) An entity (the first entity) controls a discretionary trust if, for any of the 4 income years before that year:

   (a) the trustee of the trust paid to, or applied for the benefit of:

119 *ASIC v Carey (No 6)* (2006) 153 FCR 509, 515 (French CJ).
120 ITAA1997 152-70(1) (items 2 and 3 of the table relating to trusts).
121 Contrast, for example, ITAA1936 Schedule 2F s 272-5(3) which permits the Commissioner of Taxation to treat a person as having a fixed entitlement where they do not have the requisite vested and indefeasible interest in a share of income or capital of the trust.
122 Refer Australian Taxation Office, Taxation Ruling TR 2004/D25 Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (2004) [18], [64]-[65]. The Draft Tax Ruling carries uncertainty, given that it contains an accompanying note that the ATO is consulting with Treasury in relation to absolute entitlement, including the effect of a trustee's indemnity. Earlier concerns that the ATO view on the effect of the trustee's indemnity were not correct in all cases given the decision in *CPT*, were evident from the ATO response to item 15.1 of the agenda of the ATO National Tax Liaison Group Meeting dated 15 March 2006.

(i) the first entity; or

(ii) any of the first entity's affiliates; or

(iii) the first entity and any of its affiliates;

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

Although the connection to trust assets in the receivership and family law contexts was analysed by reference to a discretionary trust with less than independent trustees, for taxation purposes the ATO has historically proceeded to treat an SMSF as a non-discretionary trust.[123] Accordingly, the first of the outlined connection tests will apply such that an entity will control the trust where it, its affiliates, or the entity together with its affiliates, own or have the right to acquire ownership of interests in the trust carrying the right to receive at least 40% of any distribution of income or capital.[124] The focus on the right to "distributions" means that the issues arising from the trustee's right to indemnity addressed in *CPT* are less problematic, though do give rise to other difficulties when applied to the SMSF.

One immediate issue in applying the right to distributions test to an SMSF is uncertainty surrounding whether members "own" or have the right to acquire the "ownership" of interests in the entity. To the extent that the ATO considers that a regulated superannuation fund is a non-discretionary trust, there appears to be some acceptance that members do have some such interest. The scope for this to be the case has improved in comparison to an earlier wording of the requirement to "beneficially own, or have the right to acquire beneficial ownership" of interests in the other entity.[125] Under that scenario, it is difficult to accept that a member of a superannuation fund would hold such an interest by reference to trust law principles and therefore would not be connected to their SMSF.[126] The change in terminology does not appear to be specifically directed at the SMSF, but to focus the tests on legal ownership[127] and in the author's experience address the more commonly encountered difficulty with the test that connects a non-discretionary trust to a company.

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123 Refer Australian Taxation Office, Interpretative Decision ATO ID 2004/147 (Withdrawn) Income Tax CGT small business concessions: connected entities – 'control' of a superannuation fund (2004). The ATO ID reached this conclusion in relation to a two-member complying superannuation fund, which was presumably an SMSF.

124 ITAA1997 s 328-125(2)(a), amended by *Taxation Laws Amendment (2013 Measures No. 1) Act 2013* (Cth).

125 ITAA1997 s 328-125(2)(a), inserted by *Tax Laws Amendment (Small Business) Act 2007* (Cth).

126 Australian Taxation Office, Taxation Determination TD 2006/68 Income Tax: capital gains: small business concessions: can trustees or members of a complying superannuation fund 'control' the superannuation fund 'control' the superannuation fund in the way described in section 328-125 of the Income Tax Assessment Act 1997? (2006) [3].

127 Explanatory Memorandum, Taxation Laws Amendment (2013 Measures No.1) Bill 2013 (Cth) [1.14].

Historically, to connect a non-discretionary trust to a company, the trust had needed to "beneficially own, or have the right to acquire the beneficial ownership" of shares in a company.[128] Although there may have been revenue grounds for making such a connection, trust law principles inconveniently challenge whether a trust could ever beneficially own a share in a company.[129] Truncating the requirement to "ownership" was a practical measure to focus on the interest or the right instead of who benefits, and so a trust could own or have the right to acquire ownership of equity interests.[130] Whether the same practical approach should be adopted to resolve that a member has ownership interests in a SMSF is not clear. However, even if this was accepted the further difficulty with the test is that a SMSF does not actually distribute income or capital, but instead pays pension or lump sum benefits upon the occurrence of certain events.[131] Whether the test's 40% threshold was met to establish control may produce further difficulty, dependent on the particular composition of the SMSF.

As the distribution test requirements for a non-discretionary trust are not easily applied to the SMSF, it is useful to consider the approach to discretionary trusts. For this purpose, the first control rule for a discretionary trust is the "trustee reasonably expected to act" test. The test is relevant to the circumstances of the SMSF, since all members are trustees or directors of the trustee company and exercise a high degree of control over the fund. Under this approach, an entity will control a trust if the trustee acts or is reasonably expected to act, in accordance with the directions of that entity, its affiliates, or the entity together with its affiliates. While all relevant circumstances need to be considered, some factors include: how the trustee acted in the past; the relationship between the trustee and entity (and its affiliates); the amount of property or services transferred to the trust by the entity (and affiliates); and arrangements between the entity and people that have benefited from the trust in the past.[132] It has historically been the ATO view that an appointor having the ability to remove and appoint a new trustee, along with a sole director/shareholder of a corporate trustee, would control a discretionary trust. Although it is now conceded that the issue depends of the facts and circumstances in question,[133] the need for such a broad application was understandably due to the

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[128] Refer ITAA1997 s 152-30(2)(b), repealed and replaced with ITAA1997 328-125(2)(b) by *Tax Laws Amendment (Small Business) Act 2007* (Cth).

[129] This issue was considered, although not ultimately resolved, in the context of the predecessor ITAA1997 s 152-30(2)(b) in *FCT v Altnot Pty Ltd* (2014) 218 FCR 556, 558-559 (Pagone J).

[130] ITAA1997 s 328-125(2)(b), amended by *Taxation Laws Amendment (2013 Measures No. 1) Act 2013* (Cth).

[131] Australian Taxation Office, Taxation Determination TD 2006/68 Income Tax: capital gains: small business concessions: can trustees or members of a complying superannuation fund 'control' the superannuation fund 'control' the superannuation fund in the way described in section 328-125 of the Income Tax Assessment Act 1997? (2006) [2].

[132] Australian Taxation Office, *Small business entity concessions* (4 October 2016) <https://www.ato.gov.au/Business/Small-business-entity-concessions/Eligibility/Aggregation/Connected-with-you/?anchor=Trusts#Trusts>.

[133] Australian Taxation Office, Taxation Determination TD 2006/67 (Withdrawn) Income tax: capital gains: small business concessions: does a person who has the power to remove the trustee of a discretionary trust

reality that the real controllers of discretionary trusts may treat trust assets as their own, notwithstanding the existence of a seemingly remote arm's length appointor and independent director responsibilities. In that regard, it is easy to make a correlation to the control and benefit approach adopted by the Family Court. The taxation approach is even more flexible by having separate control or benefit tests, each of which is sufficient to establish a connection without recourse to the other.

The second control rule to connect a discretionary trust is the "pattern of distributions" test. The test is retrospective by examining the distribution pattern of income or capital paid or applied by the trustee for the four years prior to the income year in question. The range of potential controllers is broad and covers recipients that have since been excluded from any class of beneficiary. In ascertaining whether distributions meet the required 40% threshold, both income and capital paid or applied are separately tested.[134] Trust law and the trust deed will be instructive in determining whether an amount is capital or income for this purpose.[135] Like the right to distributions test, the difficulty in satisfying the second control rule will be that SMSF members do not actually receive distributions of income or capital, and in any event may encounter further difficulty in meeting the 40% threshold.

Conclusion – taxation law

The importance of taxation to the existence of the SMSF is paramount and for this reason tax law control and benefit approaches to connect beneficiaries and other entities to trust assets are particularly useful for their potential application to SMSF regulation. However, the SMSF has historically been treated by the ATO as a non-discretionary trust for the purpose of the "connected with" test, and on that basis it remains unlikely that a member and SMSF assets would be aggregated. This is due to the difficulty in demonstrating the existence of ownership interests, along with an absence of distributions of income or capital to the member in order to meet the 40% threshold.

It would seem that the first control test for a discretionary trust may be more appropriate to the SMSF's substance. This test examines whether the trustee of the trust acts or is reasonably expected to act in accordance with the direction of another entity, its affiliates or the entity together with its affiliates. The test does not exclude the possibly for multiple controllers, though joint decision making may invite argument that neither entity controls the trust and so is not without some difficulty. Nonetheless, as a matter of broad principle the test reveals continued support for the control and

and appoint a new trustee control the trust for the purposes of subparagraph 152-30(2)(c)(ii) of the *Income Tax Assessment Act 1997*? (2006); Australian Taxation Office, Interpretative Decision ATOID 2008/139 (Withdrawn) Income Tax CGT: small business concessions – whether appointor controls discretionary trust (2008).

134 Refer ITAA1997 s 328-125(4)(b).

135 *FCT v Bamford* (2010) 240 CLR 481; Australian Taxation Office, Interpretative Decision ATOID 2008/138 (Withdrawn) Income Tax CGT: small business concessions – control discretionary trust (2008).

benefit approach to help overcome trust law distinctions of asset ownership. The substance or economic ownership of trust assets is revealed for taxing purposes, even though under trust law the beneficiaries (and other entities) do not under have ownership individually or collectively in the property of the trust.[136]

5.3.3 *Consequences for the SMSF*

Although a case can be made to differentiate the unique position of the SMSF from other types of regulated superannuation, it nonetheless appears that a member's interest in SMSF assets under trust law principles will fall low on a continuum of property interests. Yet by examining statutory approaches to private trust estates in receivership, family and taxation law it is evident that trust law distinctions concerning ownership of trust property do not prevent legislation from achieving its particular statutory objectives. In each case, the trust framework has been developed so as to address the substance of the arrangement and ensure that assets are not excluded from consideration simply because a person placed them in trust, but continues to control or be in a position to benefit from them. This does not mean that the trust framework is disregarded; instead a statutory connection is made so as to attribute trust assets to its beneficiaries or some other controlling entity, as if they were so owned. Context remains critical in making that connection, and it is important not to equate this de facto type ownership with ownership more broadly under general law, which may yield further unintended consequences.[137]

Given these statutory accommodations of the trust, there are grounds to suggest that a similar approach could be adopted for the purposes of SMSF regulation. The guiding principle would be to accept the trust framework, but to focus on whether the SMSF as the mechanism for self-directed member investment has been conducted in compliance with the statutory regime. The primary focus would be on whether SMSF activities adhere with the sole purpose test and observe the more specific investment restrictions. Those matters require minimal guidance from the trust framework and may largely reflect how the ATO already conducts itself as regulator in accordance with its compliance approach. In dealing with non-compliance the policy emphasis should be that, notwithstanding the trust framework, members have voluntarily chosen to be self-directed in their superannuation affairs and should bear ultimate responsibility. Consistently, many of the consequences for non-compliance could apply to the decision-maker concerned without having to distinguish their trustee and member

[136] *Gartside v Inland Revenue Commissioners* [1968] AC 553, 607 (Lord Reid), 615 (Lord Wilberforce).
[137] This context is highlighted to exclude interests of members in a superannuation fund from being considered under the CGT concept of absolute entitlement. Refer Australian Taxation Office, Taxation Ruling TR 2004/D25 Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (2004) [6], [136]-[139].

capacities. A number of more recent reforms to the SISA have already moved in this direction. For example, orders to complete an approved education course[138] will in effect apply to the individual concerned, since the goal is to improve that individual's knowledge and does not sensibly require that knowledge be learned in a particular trustee or director capacity. Similarly, restricting a trustee's right to indemnity to recover SISA-related penalties[139] in effect makes these penalties a liability of the individual concerned without recourse to SMSF property.

However, the substance of the SMSF and the particular unsuitability of the trust framework canvassed throughout this thesis provides reason to go beyond an approach that merely accommodates the existence of the trust with specific statutory intervention. While the receivership, family law and taxation contexts may unavoidably encounter a variety of trusts established for many different purposes, the SMSF has a narrow operation. It is a creature of statute whose existence is defined by two linked co-dependencies, the availability of taxation concessions and adherence to statutory restrictions limiting its activities. Beyond supporting the retirement income objective the SMSF has no further role. Accordingly, the consequences of changing the existing trust framework would be contained, while raising the possibility for greater consistency with the substance of the arrangement. The objective of any new model would remain focussed on restricting investment behaviour, but adopt a structure that squarely focusses on the substance of the SMSF. On that basis, those individuals who wish to utilise the SMSF platform to self-manage their superannuation affairs would be recognised as being both decision-makers and responsible for non-compliant conduct. This approach is examined in Chapter 6.

[138] SISA s 160.
[139] SISA s 168.

CHAPTER SIX: BEYOND THE TRUST

6.1 Introduction

The analysis in Chapter 5 revealed that legislative improvements could be made to the trust framework to improve its suitability for the self-managed superannuation fund (SMSF), comforted by the fact that trust law principles have already been modified in a number of other statutory contexts so as to achieve some higher policy objective. However, while that approach may be less controversial it carries a degree of resignation, given that the trust and the core incidents of trusteeship following the adoption of that structure are frequently unsuitable for the SMSF context. An attempt should be made to locate a better solution than simply trying to legislatively limit the incompatible features of the trust.

The suggestion is to go beyond the decision in the 2010 Super System Review Final Report[1] (Cooper Report) to support the retention of the trust framework. It should be conceded that the trust framework, with or without statutory modification, is unsuitable for its purpose and therefore must be abandoned. In its place, the SMSF would transition to adopt a purely statutory existence. The SMSF member would, either alone or jointly with no more than three other persons as tenants-in-common, own and invest the SMSF designated property. The members' rights over the designated property would be restricted to ensure consistency with the retirement income objective, consistent with the existing basis to restrictions on the actions of a SMSF trustees.

The proposal does not merely accommodate, but endorses the SMSF's substance through an alternative existence. It is consistent with, but extends, the member focus endorsed through the Cooper Report's set of SMSF principles and choice architecture for regulated superannuation. Although the approach represents a significant change, diminution of property rights is by no means novel and commonly occurs through the lodgement of caveats, easements and rights-of-way. In order to minimise the costs of tax compliance, the SMSF would be recognised as a taxable entity and so alleviate the need to issue assessments to each individual participant.

6.2 Endorsing substance – an alternative existence

6.2.1 Reviving the structural discussion

As canvassed in Chapter 5, the Cooper Report gave some consideration to an alternative structural framework for the SMSF but recommended against such a change.[2] Accepting that decision, statutory

1 Superannuation Review Panel, *Super System Review Final Report* (2010).
2 Refer section 5.2.3 of this thesis.

precedents reveal a willingness to achieve Commonwealth Government (Government) policy objectives by displacing trust law principles with specific legislative rules. Consistently, it would also be possible to retain the SMSF trust framework, yet have regulatory restrictions and consequences of non-compliance apply directly to participants, without distinguishing member-trustee capacities. That approach may represent a palatable middle ground, although exudes a resignation that removing the trust is just too hard. However, the perceived difficulty of the task should be no reason to prevent at least some preliminary analysis to support the case for more extensive structural reform. The attraction of an alternative structure is the prospect of starting with a suitable framework, rather than making an unsuitable one more acceptable through statutory accommodation.

Like the trust framework, the more established legal structures offer some advantage of certainty regarding their applicable legal principles. However, it is important that the structure does truly align to the substance of the SMSF, or risk replacing one unsuitable framework with another. The decision to accept or exclude existing structures will likely involve compromise, since some characteristics may be suitable while others are unsuitable. The more common options of a company, joint venture or partnership have been excluded as viable alternatives, notwithstanding they may each have suitable features. The difficulty with a corporate structure is the basic inconsistency between the close connection of SMSF members and fund assets and the distinct separation of shareholders from company property.[3] Implicit in the joint venture and partnership structures is the need for more than one participant, which is unsatisfactory given the prevalence of single member SMSFs.[4] More recent innovations, such as investor-directed portfolio services[5] are also worthy of consideration given their potential for investor autonomy, but prove unsatisfactory due to their continued reliance on the trust model.

While not seeking to permanently exclude existing structures from future consultation, they share the common deficiency of requiring extensive statutory intervention to overcome their core characteristics so as to improve their suitability for the SMSF. The intention of the foregoing is not to compare the relative suitability of the discarded alternatives, but instead focus on what may be left once the alternatives are eliminated. What remains is the SMSF as a new statutory platform, having the attributes that reinforce participant-directed investment and responsibility for decision-making.[6] In suggesting this vehicle a degree of realism is necessary, namely that the primary intention is to revive

3 The nature of a share is a chose in action, intangible personal property giving shareholders certain rights that may vary depending on the type of shares in question.

4 Refer section 3.3.2 of this thesis for discussion of this statistic.

5 Refer Australian Securities and Investment Commission, ASIC Regulatory Guide 148 Platforms that are managed investment schemes (2013) for an explanation of these products.

6 Although recommending the trust framework is retained, the suggestion of a statutory framework is not without foundation given than it was raised for consultation to inform the Cooper Report. Refer Superannuation Review Panel, *Phase Three Structure Issues Paper* (2009) 30.

the structural discussion rather than present all aspects of a solution. Yet for a discussion that is all too often sabotaged by an unwillingness to move past historic reverence for the trust, even a small contribution may prove significant in demonstrating that scope for structural reform does truly exist.

6.2.2 The SMSF investment platform

It is proposed that the attributes of the new SMSF investment platform would be defined in legislation, as with the existing structure, though would no longer rely upon on the trust framework. In this regard, the SMSF becomes a more pure creature of statute and increasingly relies on the legislature to state what restrictions and standards of participant conduct are required. That approach is similar to the prescriptive detail often arising in taxation law, and is fitting given the role of the Australian Taxation Office (ATO) as regulator and SMSFs' dependency on taxation concessions for their lifeblood. To the extent necessary and subject to any overriding statutory requirements, the legal framework will be supported by contract and property law to guide participant interactions between themselves and external parties. By removing the trust and focussing on the participants who have chosen a self-directed approach to their superannuation affairs, the new approach will create a legal framework that is aligned to the substance of the SMSF.

There are four key aspects of the SMSF investment platform that are to be addressed, providing the basis for the vehicle, though inevitably leaving scope for further work at a detailed level and the need for public consultation. Perhaps the most important matter is to provide a new statutory definition of the vehicle. Essentially, what is proposed is a registered investment comprising of a participant or association of not more than four participants, who voluntarily agree to pursue the objective or common objective of self-directed retirement income saving. Next, it is important to reiterate the co-dependency of the vehicle with taxation concessions. For ease of tax administration, the new SMSF investment platform will continue the existing approach and be recognised as an object entity for taxation purposes. Next, is the related co-dependency of legislative restrictions over the conduct of SMSF participants. It is proposed that these restrictions be located in a separate Act rather than through exception under the existing *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) one size-fits-all approach. Lastly, it is important to explain how property in connection to the platform is to be held and identified. The components of the new SMSF investment platform are illustrated as follows:

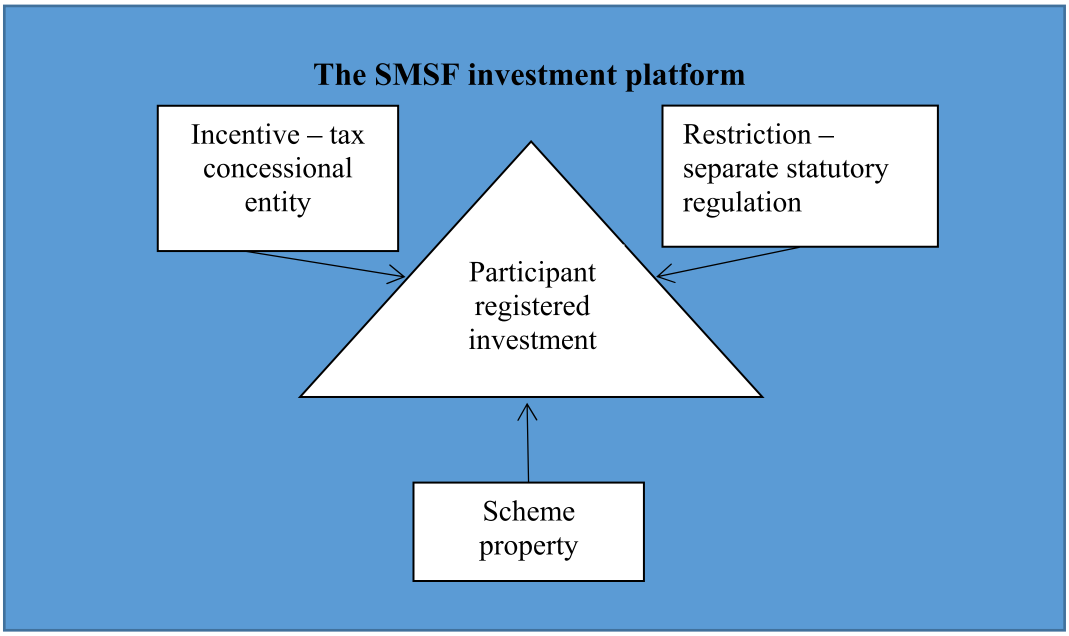

Figure 1: The SMSF investment platform

6.2.2.1 Participant registered investment

Moving from the existing premise that a SMSF be constituted by trust, the first task is to prescribe the features of its replacement. An acceptable definition is reached through modest revision and some enhancement to the existing SMSF definition in the SISA. The first revision is to move the focus from fund trustees to SMSF participants. This represents an important shift to ensure that the substance of participant direction and control is reflected in its legal framework. Secondly, the removal of the trust structure means that the definition can be consolidated, being unnecessary to deal separately with single member funds in a way that avoids the merger of legal and equitable estates. Thirdly, the role for a corporation in the SMSF definition is removed. While a corporate trustee might reflect best practice under the existing framework,[7] it is perceived as unnecessary by the vast majority of SMSF participants[8] and beyond some representative capacity is incompatible with the close relationship between participants and fund property.

[7] Bryce Figot and Tina Conitsiotis, 'Why your SMSF should have a sole purpose corporate trustee' (2011) 46(3) *Taxation in Australia* 109.

[8] The percentage of non-corporate SMFS trustee registrations for more recent years were: 2011(89.75%), 2012 (90.40%), 2013 (90.43%). As at 30/6/2013 75.79% of SMSFs did not adopt a corporate trustee. The ATO statistical tables have subsequently changed their format and more recent trustee data is not published. Australian Taxation Office, *Table 6: Trustee type* (2013) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/?page=32>.

Building on these modifications, the definition is enhanced by specifying that the vehicle must be a registered scheme. This is the essence of how the SMSF investment platform exists and is a condition that requires some discussion. The escalation of registration to a definitional level will underscore the fact that the platform is purely a statutory creature distinguishable from the trust framework adopted by other superannuation funds. However, most importantly the content should be practical in the sense of giving participants guidance on what is expected of them to create the statutory scheme. On that basis, it is proposed that a registered scheme be defined as a scheme for which the Commission of Taxation has advised in the approved form to be a registered scheme upon: (1) lodgement with the ATO of a valid registration application; and (2) notification to the ATO of a participation bank account. Although further instruction would be needed from the ATO or by way of regulations, the basic elements and their ordering are clear: the ATO would advise that the scheme is a regulated scheme and that this may occur after lodging an application form, followed by notification of a participation bank account. This approach contrasts to the circularity of existing arrangements, in that a SMSF without assets cannot be provided with a Tax File Number (TFN) or Australian Business Number (ABN),[9] yet without those identifiers the SMSF will also find it difficult to obtain release of a rollover amount from another regulated superannuation fund or open a bank account to receive funds.

The remaining matter to be addressed is that the existing restrictions concerning employment, remuneration and size are to be maintained. The employment and remuneration constrains remain important safeguards to ensure that the decisions and actions of the SMSF participants are not influenced by matters unrelated to retirement income saving. Restricting the size of the platform to four participants will inevitably draw a range of views as it has for the existing structure, but is arguably a subsidiary issue given that the current participation is overwhelming skewed towards single and two-member funds.[10] Accumulating these inclusions and the preceding matters, the following definition is proposed:

SMSF basic conditions

(1) Subject to this section, a superannuation fund, is a *self managed superannuation fund* if and only if it satisfies the following conditions:

(a) it has fewer than 5 participants;

(b) no participant of the fund is an employee of another participant of the fund, unless the participants concerned are relatives;

9 Refer Australian Taxation Office, *Register your fund* (25 July 2016) <https://www.ato.gov.au/Super/Self-managed-super-funds/Setting-up/Register-your-fund/>; Commonwealth of Australia, *Australian Business Register* <https://abr.gov.au/For-Business,-Super-funds---Charities/Applying-for-an-ABN/Apply-for-an-ABN/>.

10 Refer section 3.3.2 of this thesis for discussion of this statistic.

(c) no participant of the fund receives any remuneration from the fund or from any person for any duties or services performed by the participant in relation to the fund;

(d) it is a registered scheme.

It is hoped that these requirements produce a clear definition that improves public confidence in the SMSF sector, but also reiterates to participants that active involvement is essential from the outset.[11] The driving principle is that participants have decided to be self-directed in their retirement income arrangements; it is their decision to pursue that approach through a statutory registration process and in doing so they accept full regulatory responsibility. The absence of the trust framework ensures that this substance does not become clouded by legal principles that are inappropriate for the SMSF context. Public confidence in the sector is particularly strengthened at the point of establishment, through the overriding importance of registration and the need for positive action by participants at commencement. In this regard, the definition will be supported by improved ATO integrity procedures and participant guidance.

Robust procedural guidance should complement the SMSF definition, with particular focus on integrity surrounding the creation of a registered scheme. In this regard, the deficiencies identified by the Cooper Report with the existing TFN and ABN application procedures are informative, identifying a lack of identity checks during the registration process, the need for adviser identification and an absence controls surrounding SMSF naming conventions.[12] Although the ATO has since improved its SMSF application procedures to mitigate the risk of identity fraud,[13] adviser identification and SMSF naming conventions remain outstanding matters. Adviser identification would provide useful empirical data connecting advisers and SMSF outcomes; as well as inform whether participants actually seek establishment advice and more generally their degree self-directedness in entering the SMSF sector. Controls surrounding SMSF naming conventions would introduce consistency with the naming restrictions of the business names register,[14] eliminate name duplication currently evident on Super Fund Lookup[15] listings and reduce the scope confusion by counterparties. In terms of supporting instruction, it is important that guidelines provide clear chronological steps consistent with the theme that participants take control over their retirement

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11 Rather than a more passive activity such as buying an SMSF trust deed, the proposed registration process is intended to invite participants to ask what action they need to take to register, requiring them to demonstrate their identity and test their motivation to choose the SMSF route.

12 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 253-255.

13 The online SMSF registration form submitted through the Australian Business Register contains a range of integrity mechanisms to ensure that information entered, such as address details, telephone numbers and TFNs, fall within a valid range before accepting submission of an application.

14 Refer Australian Securities and Investment Commission, *Search business names register* <https://connectonline.asic.gov.au/RegistrySearch/faces/landing/bn/SearchBnRegisters.jspx?_adf.ctrl-state=2k5a34sfy_4>.

15 Commonwealth of Australian, *Super Fund Lookup* <http://superfundlookup.gov.au/>.

income arrangements, rather than encouraging reliance on external advisers for what is an important but otherwise straightforward task. It is suggested that the ATO would publish the following guidance:[16]

1. Submit on-line registration form to the ATO to establish an SMSF, nominating all participants and paying a prescribed fee.
    a. The fee would be non-refundable and commensurate with the cost of a basic SMSF trust deed to deter frivolous applications.
    b. The online form would no longer record unnecessary trust related fields, though be expanded to include adviser identification.
    c. A unique SMSF name would be automatically generated to avoid confusion with existing funds already registered and listed under Super Fund Lookup. For example, the first letter of each participant's name and 7 digits.
    d. An exception would be made to enable a fund to be provisionally established without any assets.

2. The participant(s) to present and each provide 100 points of identification at a chosen financial institution as prerequisite to opening an initially inactive bank account in the name of the SMSF.

3. The SMSF bank account and participant details are provided to the ATO by the financial institution enabling it to verify the identity of the participants attending the financial institution with the details lodged in the on-line registration form sent to the ATO.

4. The ATO completes risk assessments against each individual participant, for example raising exception to disqualified persons.

5. The ATO provides the participant(s) with a statement confirming the outcome of their registration application. Where registration is successful the statement confirms the SMSF's TFN and ABN. An unsuccessful application may be suspended pending correction or terminated.

6. The ATO advises the financial institution whether the details previously provided have been verified, and where successful, the SMSF's ABN.

7. The participant(s) of the ATO verified SMSF present at the financial institution, advising the institution of the SMSF's TFN and requesting that the account be activated.

[16] These requirements incorporate and build upon the recommendations outlined in Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 253-254.

8. Maintaining existing arrangements, the status of the SMSF will remain "Registered – status not determined" until compliance is determined upon lodgment of first annual return.

6.2.2.2 Incentive – tax concessional entity

Moving from a trust structure to a pure statutory framework may suggest that significant tax law change is necessary to ensure the SMSF investment platform can access the tax concessional regime available to other complying superannuation funds. Yet this is not necessarily so given that, despite the adoption of a trust framework, the SMSF does not in any case exhibit the conduit type characteristics associated with the trust.[17] Consistent with the deferred nature of regulated superannuation, the basic taxation approach to an SMSF is contained in Division 295 of the *Income Tax Assessment Act 1997* (Cth) (ITAA1997), rather than the trust taxation regime located in Division 6 of the *Income Tax Assessment Act 1936* (Cth) (ITAA1936). As a full self-assessment taxpayer,[18] income is accumulated and assessed against the trustee of an SMSF,[19] rather than attracting higher taxation rates of trust taxation for failure to create present or specifically entitled beneficiaries.[20] Although it is the trustee that currently receives a deemed assessment upon lodgement of the SMSF tax return, it is not inconceivable that the SMSF itself could assume this role as a separate taxable entity with primary responsibility for scheme taxation obligations.

The taxation assessment of the SMSF rather than each individual participant will provide significant administrative and compliance cost advantages. In the usual case, participant contribution to the SMSF's assessed liability would be proportionate to the earnings allocated to their account balance, taking into consideration their pension or accumulation status. Essentially, that is consistent with how a member account balance is determined (net of tax) at year end under the existing taxation approach. However, while the SMSF becomes primarily responsible for any ensuing tax liabilities and payment to the ATO, the absence of the trust legal framework means that some clarification is necessary in terms of participant liability.[21] Consistent with a participant-focussed model endorsed in the Cooper Report,[22] the ultimate responsibility for scheme taxation liabilities should fall to participants. Beyond that point, a further question is whether participant liability should be several? While several liability

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17 In any event, trust conduit theory has significant limitations when applied in a taxation context. The better view is that, absent statutory modification, the character of income under trust law does not inform the character of the share of net income assessed to a beneficiary. Instead a proportionate approach to trust income is applied to determining a beneficiary's share of net income a trust. Refer *FCT v Bamford* (2010) 240 CLR 481.

18 ITAA1936 s 6(1(e) (definition of "full self-assessment taxpayer").

19 ITAA1936 s 166A.

20 ITAA1936 ss 99, 99A

21 The existing positon in that individuals acting as trustee of an SMSF are jointly and severally liable for any actions taken against the fund. See, for example, *Shail Superannuation Fund v FCT* (2011) 86 ATR 339, 349 (AATA).

22 Refer section 5.2.1 of this thesis for discussion.

may seem appropriate on equity grounds, having a separate taxable entity combine with different levels of participant legal liability may prove cumbersome for the ATO. Fortunately, to the extent that policy does require liabilities to be joint and several, there is accepted precedent in a tax consolidation context to allocate the income tax liability of a head entity to individual group members through a tax sharing agreement. A similar approach could be employed to allocate joint and several participant liabilities in relation to SMSF taxation debts.

Allocating primary responsibility for scheme taxation liabilities to the SMSF but ultimate responsibility to participants builds improved consistency with the principles underpinning the taxing architecture for regulated superannuation. That is because, despite the current reliance on the trust, the taxing approach to a complying superannuation fund reiterates the importance of the member by using features comparable to those where fund assets are held directly by the members. Perhaps most fundamentally, the Capital Gains Tax (CGT) regime is accepted as the primary code for calculating gains and losses of a SMSF,[23] which would also be expected where those gains or losses on investment disposals related to an individual taxpayer. The underlying CGT calculation is also consistent in that both an individual taxpayer and an SMSF trustee can make a discount capital gain on assets held for more than 12 months[24] or choose to index elements of assets' cost base.[25] A further similarity is that where an individual or SMSF trustee receives a franked distribution as a member of another entity, both are eligible to claim a refundable tax offset.[26] In light of these examples, the revised SMSF investment platform is to some extent a framework merely catching up with taxation law, which already looks beyond the trust in its taxing approach and is influenced by principles applicable to participants in their individual capacities.

Specific reforms will no doubt be necessary to Part 3-30 of the ITAA1997, which contains the code for the taxation of superannuation. The changes will need to accommodate the SMSF investment platform as a separate taxable entity and move away from the existing trustee focus. Although requiring careful planning, it is not expected that the extent of change would be insurmountable. The first reason for this is definitional. In particular, a large number of provisions that apply to the trustee of a SMSF are in fact addressed to the broader defined expression "superannuation provider".[27] Extension to the SMSF investment framework can be achieved by expanding the definition of superannuation provider to include the SMSF platform, in addition to existing categories of a trustee of the fund for a superannuation fund or an approved deposit fund and an RSA provider for a

23 ITAA1997 s 295-85.
24 ITAA1997 ss 115-100(a)(i), (b)(i). Note different rates of discount apply.
25 ITAA1997 s 114-5(2) (item 2 of the table relating to the trustee of a complying superannuation fund).
26 ITAA1997 s 67-25.
27 ITAA1997 s 995-1(a) (definition of "superannuation provider").

retirement savings account.[28] A similar approach might also be applied to the word "member" that appears extensively in Part 3-30 of the ITAA1997; defining its scope to include a SMSF participant.[29] The second reason limiting the necessary change to Part 3-3 of the ITAA1997 is that the substantive provisions are focussed on detailing rules for the superannuation contributions, investment and benefits payments. These matters are resolvable without reference to the legal framework relevant to each superannuation provider.

A further issue to be resolved is how asset ownership by participants at law is reconciled with taxation at the entity level. In this regard, it is proposed that SMSF assets would be held as tenants-in-common with other participants, which is quite different from the existing limited beneficial interests held by members. The taxation concern is that where participants' interest in scheme assets amount to ownership, then capital gains or losses and income or expenditure in relation to those assets might be taken into account when calculating the participant's tax position for non-superannuation related purposes and taxed at marginal rates. Fortunately, a way forward has already been prepared under an existing taxation framework in the context of absolute entitlement.[30] In that regard, the view is taken for the purpose of CGT event E5 of the ITAA1997 that a member of a SMSF is not treated as if they are absolutely entitled for CGT purposes to assets of the fund or assets held in their account, irrespective of whether they have met a condition of release.[31] The CGT concept about the entitlement of a beneficiary to trust assets simply does not apply, since the legislative scheme that regulates the taxation of superannuation, payment of benefits and taxation of benefits in Part 3-30 of the ITAA1997 provides a complete code on those matters.[32] Accordingly, there is precedent to show that the legal relationship of members to fund assets is not determinative of taxation outcome, nor should it necessarily prevent the SMSF investment platform being the relevant taxable entity. If necessary, this positon could be reinforced by stating that particular CGT events do not occur to participants in relation to SMSF assets, such as CGT event A1 arising where a change of ownership occurs.[33]

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28 ITAA1997 s 995-1(a), (b), (c) (definition of "superannuation provider").

29 The word member is not a defined term for the purposes of ITAA1997 Part 3-30, though is defined for a range of other purposes in ITAA1997 s 995-1.

30 Australian Taxation Office, Taxation Ruling TR 2004/D25 Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (2004).

31 Australian Taxation Office, Taxation Ruling TR 2004/D25 Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (2004) [138].

32 Australian Taxation Office, Taxation Ruling TR 2004/D25 Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (2004) [139].

33 ITAA1997 s 104-10.

6.2.2.3 *Restriction – dedicated statutory regulation*

The revised investment framework provides an opportunity to consider moving SMSF regulation from the SISA to dedicated legislation. This was a matter considered by the Cooper Report, with a focus on whether it might improve sector efficiency by reducing the compliance burden and costs for trustees.[34] That objective remains important, though the new legal framework will also put the SMSF at further odds to other trust-based superannuation structures regulated under the SISA regime. The ability to accommodate the revised SMSF under the already strained one-size-fits-all approach of the SISA will become increasingly difficult, particularly given the typically trustee-centric nature of its provisions. The SISA would need to be extended to address SMSF participants or otherwise adopt some new expression, separately defined to include both trustees of non-SMSF regulated superannuation funds and SMSF participants. Alternatively, there may be scope to treat the SMSF itself as the responsible entity for regulatory purposes, though as with the taxation approach participants would take ultimate responsibility, given that the SMSF would not have a separate legal personality.

Support for dedicated legislation continues to build from the general complexity of the current drafting approach in the SISA,[35] with some provisions applying solely to the SMSF or APRA-regulated sectors and other provisions applying to all sectors, with or without modification. That approach can lead to inefficiency,[36] particularly for the SMSF sector which is potentially less versed in legislative interpretation than APRA-regulated funds with access to technical personnel. It may also lead to administrative delays, given the desire to maintain some degree of interpretative consistency, despite the different contexts and regulatory approaches applied to the SMSF and APRA sectors. These difficulties persuaded the Cooper Report to recommend that the SISA be re-written and restructured to separate and identify the areas of regulation having broad application and those that are specific to particular sectors.[37] Stopping short of a new Act, this partial resolution appeared to balance the desire to remove unnecessary regulation and provide clarity in the law with the need to retain a level playing field between the different superannuation sectors.[38] It also follows the earlier recommendation to retain the SMSF trust framework, which maintained structural consistency between all regulated superannuation funds and mitigated the case for separation of the models on the grounds of substance or the choice architecture. The removal of the trust eliminates this impediment to change.

34 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 229, 326-327.
35 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 229.
36 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 326.
37 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 327.
38 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 327.

Provided sufficient consideration is given to the principles of maintaining a level playing field, the different structure, context and compliance-based approach to the SMSF investment framework provides good reason to go beyond simply restructuring the SISA to adopting dedicated legislation. In doing so, it is also important to recognise that the principle of a "level playing field" should not be overbearing.[39] Basic consistency between the sectors is retained with a primary focus of SMSF regulation on the sole purpose test and supplemented by the more specific investment restrictions, combined to ensure that superannuation assets are used properly to support retirement incomes. Beyond this point a response to create dedicated legislation that is unwilling to respond to the particular circumstances and behaviour of SMSF participants for fear of changing the status quo would be inadequate. That approach would also be inconsistent with the legislative response following the Cooper Report, specifically accommodating the features of the SMSF in developing a broader range of consequences for non-compliant conduct.[40] The development of SMSF-related administratively binding regulatory guidance would support the resolution of technical regulatory issues, including considered departures from principles applicable to APRA-regulated funds. This measure has already gained broad support[41] and could extend the ATO's existing SMSF Ruling program.[42]

Particular inclusions for the SMSF context

Dedicated legislation not only enables more focussed SMSF regulation and elimination of the requirements solely applicable to other regulated superannuation funds, it may also encourage the inclusion of matters that are not currently addressed through the SISA. While the range of SMSF regulatory issues is potentially broad, the non-exhaustive items considered here are limited to those connected with the self-direction and compliance-based approach to the SMSF investment framework. Whether or not they are ultimately accepted is a matter for future consultation. The case for distinguishing their APRA-regulated counterparts is also dynamic, in that SMSF issues are likely to evolve over time with change in participant demographics[43] and the identification of sector specific trends.[44] Particular care must be taken to ensure that further regulation actually responds to the unique SMSF context, rather than extraneous political or industry self-interest. The case for additional regulation should also be justified against the important, yet not overbearing, principle canvassed in

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39 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 327.

40 Refer SISA Part 20, inserted by *Tax and Superannuation Laws Amendment (2014 Measures No. 1) Act 2014* (Cth) introducing administrative directions and penalties for contraventions relating to self-managed superannuation funds.

41 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 229, 230.

42 There are currently nine finalised SMSF Rulings, which is small in comparison to the large number of finalised Taxation Rulings.

43 For example, the capacity of aging participants to extinguish their obligations.

44 For example, growth of limited recourse borrowing.

the Cooper Report of maintaining a level playing field between SMSF and APRA-regulated superannuation funds.[45]

One matter that may improve sector efficiency is to have the regulator maintain a standard SMSF constitution. Given the large number of SMSFs in existence, the potential to avoid duplication of effort and cost is significant. The constitution could either be mandated or operate in default similar to the approach adopted by the *Corporations Act 2001* (Cth) (CA) replaceable rules.[46] By removing the need for a private treaty the mandated approach is likely to bring the most significant efficiency gains through sector uniformity. Uniformity would assist with the interpretation of SMSF constitutions and automatically ensure that deeds were kept up to date for legislative change. Mandatory adoption would also be consistent with the SMSF transitioning to a purely statutory vehicle, and act as a further persuasion that it must be dedicated to prescribed retirement income purposes. While supporting the idea of a standard deed, the view of industry that in a large number of cases SMSFs would still choose a tailored deed appears to have persuaded the Cooper Report not to recommend either approach. Instead, the recommendation was for the SISA to be amended so as to deem anything permitted by the SISA or taxation acts to be permitted by a SMSF deed.[47] While that is less intrusive and is effective to some extent, a mandatory route should be reconsidered given that the trust framework no longer provides the structure for the SMSF. The absence of the trust and focus on substance supports the case for increased legislative intervention, recognising that the private nature of participant self-direction exists solely within a public context of improving retirement incomes.

A further change that may improve retirement incomes is the introduction of portfolio restrictions to support the SMSF investment framework. Unsurprisingly, this restriction has historically received limited support from participants deriving maximum investment choice or from the Government, given the potential inconsistency of further regulation with improving financial system competition and efficiency.[48] Yet, as discussed in Chapter 4 that objective proceeds on an assumption that investors have the ability to make informed decisions.[49] Reluctance to impose portfolio restrictions was also historically supported by the SMSF trust framework that maintained important distinctions between the office of trustee, trust property and beneficiaries. Despite the substance of the arrangement seeing the portfolio manager, member and trustee as one and the same, the trust form continued to impress the separate capacities held by those same persons. While members could direct trustees to purchase particular assets that accord with the overall investment strategy of the

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45 Refer Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 327.
46 Refer *Corporations Act 2001* (Cth) Pt 2B.4.
47 Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 258.
48 Peter Phillips, 'Self Managed Superannuation Funds: Time for Portfolio Controls?' *Unpublished Working Paper*.
49 Refer section 4.2.3 of this thesis.

superannuation fund, the trustees of a SMSF remained subject to the same statutory duties as other funds, including the duty to formulate and implement an investment strategy.[50] The removal of the trust and transition to a legal framework aligned to substance removes this obstruction to change.

The design of SMSF portfolio restrictions would however require careful thought. Their role would be different to the SISA covenants and general law incidents of trusteeship that protect member interests from trustee conduct inconsistent with the retirement income objective and terms of the trust. In contrast, the objective of SMSF portfolio restrictions would be to protect the interests of participants from themselves, yet for the same overriding retirement income purpose. Although SMSF participants make conscious decisions in their own interests, portfolio controls accommodate the fact that they are unlikely to be professional investment managers, may be less familiar with basic investment theory and lack formal trustee, portfolio manager and beneficiary accountabilities. In this context, a prescriptive response could mitigate the risk that SMSF investment strategies are ill-considered, become too broad or are reverse-engineered to accommodate whatever investment choices the participants wish to make. While many SMSFs may not fall into this category, those with robust fund and investment governance frameworks would already be expected to comply with basic portfolio constraints, such as maintaining a minimum level of asset diversification. Portfolio controls would serve as a persuasive reminder to all participants that despite the flexibility and tax incentives to participate in the SMSF sector, it is for these very reasons a heavily restricted mechanism for investment.

The precise degree to which portfolios should be restricted will require judgement and is ultimately a matter for further consultation. However, the basic proposition is that SMSF investment would be constrained, both in terms of the classes of assets that are permissible and the proportions of a portfolio that certain assets could constitute.[51] This will force a risk management strategy to be adopted and limit the existing scope for inconsistency between SMSF portfolios overweight in particular asset categories, such as residential property, and APRA’s view that a well-informed investment strategy would not ordinarily permit a large portion of a regulated superannuation fund’s assets to be invested in one asset or single class of assets.[52] While the composition of member investments beyond superannuation may have informed past SMSF asset risk concentration,[53] there should be consistency with the position of APRA-regulated funds whose trustees’ primary responsibility is to consider all the circumstances of the fund. Accordingly, the extent to which

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[50] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [51].

[51] Peter Phillips, ‘Self Managed Superannuation Funds: Time for Portfolio Controls?’ *Unpublished Working Paper* 9.

[52] Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [30].

[53] Refer Superannuation Review Panel, *Super System Review Final Report, Part Two* (2010) 33.

external non-superannuation related circumstances are relevant to the statutory SMSF investment platform should be similarly limited and incidental.[54]

6.2.2.4 Scheme property

Scheme property is co-owned by participants

The removal of the trust framework is not intended to fundamentally change the restrictions on SMSF conduct or the underlying principle that regulated superannuation fund assets are to be quarantined and applied for retirement income purposes. However, the regulatory approach does need revision to ensure consistency with any revision to the legal basis on which scheme property is to be held. In this regard, it is proposed that SMSF participants enjoy shared rights over the scheme property as co-owners. The nature of those shared rights may be possessory, such as the right of participants to possess the whole of the co-owned land, or shared rights *in personam*, such as those attached to a bank account. The essential feature of the co-ownership model is that each participant is entitled to shared possession or use of the scheme property and cannot be excluded by other participants.[55] That characteristic is particularly suitable for the SMSF context, where participants mutually agree on fund decisions and for that purpose should have unimpeded access to all scheme property.

In developing this approach it is important to clarify the type of co-ownership envisaged, since co-ownership may exist as tenancy-in-common or joint tenancy. Although these alternatives have similarity, with participants under either approach enjoying shared possession of property, the SMSF will encounter difficulty in satisfying the necessary conditions to establish a joint tenancy. The requirements for that type of ownership are rigid, with participants needing to demonstrate that their rights are identical in four aspects: possession, interest, title and time.[56] Beyond these requirements, the right of survivorship is fundamental to all joint tenancies and is an unsuitable attribute for the SMSF context. While familial connected participants may want their rights over scheme property to

54 Australian Prudential Regulation Authority, Superannuation Circular No II.D.1: Managing Investments and Investment Choice (2006) [40].

55 This feature is contrast to the trust relationship, wherein the trustee and beneficiary rights are unequal and held in different jurisdictional capacities.

56 Unity of possession will exist where all participants are entitled to the shared possession of scheme property. This requirement aligns with participant responsibility for investment decision making that underscores the substance of the SMSF and ensures that participant access is unhindered. Unity of interest requires that all participants have the same interest in the right that they share. This requirement appears difficult to satisfy in the SMSF context, given that the size of a participants account balance would be expected to carry some correlation to their interest in scheme property. Unity of title means that each participant must obtain their shared right from the same source. This requirement would create difficulties where SMSF participants join, leave or make in-specie transfers to the fund, causing ownership to arise from different sources. Unity of time requires that the rights of participants arise at the same time. This requirement would present difficulty where SMSF participants to join the fund at different times.

pass to a surviving participant upon death, others may only partially want that to occur and others not at all. Where SMSF participants include business associates, friends, siblings, children or more distant relatives, there are many reasons to prevent the interests of remaining participants from automatically enlarging upon the death of another. The characteristics of a joint tenancy do not fit the SMSF context, nor are they compatible with the existing ability of regulated superannuation fund members to guide or even remove a trustee's discretion through a binding death benefit nomination.

Eliminating a joint tenancy, the tenancy-in-common will provide the SMSF with a default basis for co-ownership of scheme property.[57] That approach will ensure that the interests of participants are not subject to rights of survivorship and if necessary enable flexibility for those rights to be shared unequally. Scheme property held as tenants-in-common would pass in accordance with the will of the deceased participant or applicable intestacy rules. This departs from the current position in that the interest of a member in regulated superannuation does not devolve by will and would not form part of the member's estate, unless the trustee separately resolved to pay their benefits to the deceased estate. To maintain integrity with the objective of regulated superannuation to provide benefits to the member or their dependents upon death, it is important that a participant's will does not provide unfettered power to determine how superannuation benefits are paid upon death. Fortunately, this risk is mitigated to some extent by existing principles that require a testator to adequately provide for their spouse or de facto partner, children, and other dependants.[58] The State-based intestacy rules may also be informative in demonstrating how a claim to be a dependant could be constructed based on the degree of family relationship. The basic objective would be to provide an appropriate ordering for the receipt of benefits, prioritising dependants over non-dependants, and subject to the existing ability to influence that ordering through a binding death benefit nomination.

Rights and duties under co-ownership

Having suggested the tenancy-in-common basis of co-ownership, it is important to address the consequences following that choice in terms of the mutual obligations of participants conducting the scheme. As with the existing trustee covenants in the SISA, a code of instruction for participant interaction may be devised through statutory rules. While that may potentially involve some "borrowing" of principles from the existing SISA covenants, the binding of participants under the co-ownership framework is to be grounded on contractual and property law principles. Consistent with that change, the focus will address the horizontal-type interactions between participants in their dealings with scheme property, rather than the vertically orientated interactions occurring between a

[57] To avoid confusion, it is suggested that the proposed tenant-in-common ownership basis is confirmed through statute, either by inclusion in a definition of "scheme property" or as a separate item.

[58] Refer Gino Dal Pont and Ken Mackie, *Law of Succession* (LexisNexis, 2013) ch 15-20.

trustee and beneficiary. The content of participants' mutual obligations should reflect the fact that they have contracted to co-own property with other participants, albeit within a statutory framework designed to achieve prescribed retirement income objectives. These principles will reflect both the substance and proposed legal form of the SMSF.

In devising a statement of participant duties, reference is made to the analysis of the SISA covenants in Chapter 4 of this thesis and particularly their application to the SMSF context.[59] The SISA covenants were divided into duties concerning conduct, management and investment. In dissecting their meaning, a theme emerged that many of their interpretative ambiguities were resolvable by reference to sources other than antecedent trust law. Ultimately, conclusions were drawn on the suitability of the SISA covenants for application to the substance of the SMSF. Those conclusions are now relevant to the present task, in that the co-ownership model would reflect that substance in a legal framework and calls for the identification of appropriate participant duties. To the extent that particular SISA covenants were suitable for the SMSF, there is a good basis to preserve them, subject to some necessary refocussing to address inter se participant interactions, rather than the trustee-beneficiary context.

Addressing the SISA covenants grouped under the heading of conduct, it was determined that the duties of honesty, the standard of an ordinary prudent person and duty to act in the best interests of beneficiaries were all potentially suitable to the SMSF substance. However, their suitability was strongly dependent on the adopting an ordinary meaning of the words used in each duty, rather than being influenced by antecedent trust law principles. While the requirement for honesty adds little to an SMSF trustee's duties in later covenants or general law, it may nonetheless exert some practical influence on behaviour as a shared community value. The ordinary prudent person standard also remains suitable, to the extent that it requires participants to adopt the care, skill and diligence of the sort that an ordinary person that is careful, astute and exercises sound judgment would show in dealing with scheme property. Essentially, that was the interpretation adopted in *VCA v APRA*[60] (*VCA*), though now applied to a co-ownership context where each participant has an interest in scheme property. The standard should not draw upon trust law, nor is there any overwhelming need for enhancement as has occurred for non-SMSF regulated superannuation funds. Although the contribution of the duty to act in the best interests of participants may be limited, it is retained provided that the administrative approach to its interpretation adopted in *VCA* and *VBN v APRA*[61] (*VBN*) is applied. Accordingly, a participant may protect their position and promote their own advantages, though in the circumstance knowing that agreement must be obtained from the other

[59] Refer section 4.4 of this thesis.
[60] (2008) 105 ALD 236.
[61] (2006) 92 ALD 259.

participants, whose interests and welfare must be taken into consideration, if a course of action is to be endorsed. The hesitation surrounding this duty stems from whether it would actually add anything beyond what would already arise from participant self-interest and involvement in fund decision making. Yet even if that were the case the duty may nonetheless serve as a reminder for inclusive decision-making.

Addressing the SISA covenants grouped under the heading of management, it was determined that the duty concerning separation of assets was suitable to the SMSF substance. Consistent with the SMSF substance, the separation of scheme property from the personal assets of members was identified as an important matter of retirement income integrity, rather than being grounded in trust law. The duty remains fundamental for participants under the co-ownership model, and may attract particular scrutiny from those challenged by the absence of ownership demarcations reflected in the trust. However, in that regard the introduction of co-ownership presents an opportunity to reinforce this duty through improved asset identification measures, such as requiring scheme property to be identifiable by reference to a SMSF's unique ABN. This would remove existing uncertainties where a member appears on the property title, though giving little indication to others that the property is in fact held on trust for the SMSF members. The second covenant addressed under the heading of management was the duty not to prevent or hinder functions or powers. Consistent with the earlier analysis, it is not proposed that this requirement be adopted. To the extent that a participant wished to pursue an opportunity other than through the SMSF, they would simply refuse to support the SMSF pursuing the same. This is in contrast to a trustee, who might endorse an action as being in the best interests of its beneficiaries, yet hinder that course of action due to their different trustee and non-trustee capacities.

The remaining SISA covenant considered under the heading of investment was the duty to formulate an investment strategy. The interpretation adopted for the substance of the SMSF was that the covenant accommodates contemporary investment theory, but leaves it open to a court or the ATO to determine what theory is appropriate to the particular circumstances under consideration. While the lack of prescription combined with the flexibility of the SMSF to enable risky or narrow investment choices remains problematic, the requirement to devise, review regularly and give effect to an investment strategy remains an important duty. Where participants do apply themselves to address this duty there is a likelihood of improved retirement outcomes. However, the difficulty remains that despite best endeavours some participants may lack the ability undertake a proper and considered process of strategy formulation. One solution is to continue the duty in its current form, though operating in combination with the suggested introduction of portfolio restrictions, with participants formulating their strategy subject to basic statutory parameters. That approach would ensure that less capable participants had some de minimis level of strategy, such as asset diversification, though at the expense of restricting other participants that did not fall into that category.

Accumulating these matters, a basic statement of participant duties can be prepared. Given the significance of the shift from the trust framework, it may also be useful to reiterate up front some more basic responsibilities applicable to the co-ownership model. The approach is intended to improve upon the existing situation whereby SMSF members (trustees) may attempt to understand their duties under the SISA covenants, though potentially divorced from any understanding of the legal nature of the trust relationship upon which they apply. The additional statements are straightforward and do not raise any particular uncertainties needing further detailed explanation. Given the existing familiarity of SMSF participants with the word "covenants" in the SISA, unless significant benefit can be identified from adopting some alternative expression, it is proposed to continue using that word to express the obligations of participants. The ultimate decision on whether or not to adopt a standard SMSF constitution may well affect the location of the statement of duties, potentially within the substantive provisions of the Act, separately in the constitution or both in the Act and constitution. Where a standard constitution is not adopted, as with the existing approach under the SISA, an introductory statement will be required to clarify that if the governing rules of the SMSF do not contain obligations to the effect of the covenants, then those governing rules are taken to contain covenants to that effect.[62] Although the final content of the covenants would be subject to further consultation, the following statement provides a useful starting and provides continuity by borrowing some content from s 52B(2) of the SISA:

The covenants

The covenants are the following covenants by each participant of the SMSF:

(a) to hold their interests in scheme property as tenants in common;

(b) to share the benefit and burdens of co-owned scheme property in proportion to their interest in that property;

(c) to act honestly in all matters concerning the SMSF;

(d) to exercise, in relation to all matters affecting the SMSF, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;

(e) to perform the participant's duties and exercise their powers in the best interests of the participants;

62 Refer SISA s 52B(1).

(f) to keep the money and other assets of the SMSF separate from any money and assets, respectively:
   (i) that are held by the participant personally for non-SMSF purposes; or
   (ii) that are money or assets, as the case may be, of a standard employer-sponsor, or an associate of a standard employer-sponsor, of the SMSF;

(g) not to enter into any contract, or do anything else, that would prevent the participant from properly performing or exercising their functions or powers;

(h) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the SMSF including, but not limited to, the following:
   (i) the risk involved in making, holding and realising, and the likely return from, the SMSF's investments having regard to its objectives and its expected cash flow requirements;
   (ii) the composition of the SMSF's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
   (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;
   (iv) the ability of the entity to discharge its existing and prospective liabilities.

6.2.3 A supporting role for general law

Similar to the limited operation of trust law in the existing SMSF legal framework, there may also be some residual scope for general law obligations to apply to participant's co-ownership of scheme property. However, given that the SMSF will become increasingly reliant on statute upon removal of the trust framework, there are consistency grounds to further limit the need to go outside the legislative regime to resolve participant wrongdoing. To achieve that objective will require careful review of participant covenants and extensive consultation to ensure that they comprehensively deal with the participant relationship, though realising the difficulty in producing a completely exhaustive code. To the extent that scope does remain, equity may fill the void, intervening in circumstances where the benefits and burdens of the co-owners' shared rights are not shared proportionate to their interest in that right.

Given the expectation for equity to have limited operation due to expansive participant covenants, it is not proposed to give detailed consideration to all situations where equity might intervene.

Nonetheless, two of the more typical areas where rights and obligations of co-owners are created in equity are where a participant can establish wrongdoing or unjust enrichment. The objective is to compel a participant to pay for wrongly excluding another from the co-owned property or to pay for benefits unjustly received from the co-ownership, though both avenues are not without some difficulty. In relation to wrongdoing, a challenge is presented by the basic premise that each participant is entitled to possess or use of the entire shared right. On that basis, even though a participant takes a greater portion of the benefits attributable to a shared right they shall do no wrong.[63] Nor would a participant generally have a duty to maintain or improve the co-owned property, meaning failure to contribute to those expenditures may also not constitute wrongdoing.

Unjust enrichment may provide a participant with an alternate basis to compel another to properly share the benefits and burdens of co-ownership. The remedy does have limitations in that a co-owner cannot be compelled to pay for benefits that another confers upon themselves, or that they do not want.[64] The SMSF context narrows the scope further, in that all participants are part of the decision-making process, reducing the opportunity for one participant to pursue a unilateral course with scheme property. Potentially, one area where unjust enrichment might be useful is where a participant is compelled to pay the liability of another, such as a taxation liability or government levy, since the element of compulsion overcomes first-mentioned limitations. Yet on closer inspection the ability for a participant to extinguish SMSF liabilities from their personal funds is limited, given that SMSF assets and the personal assets of its participants must be kept separate. Where a participant pays the liability from the designated SMSF bank account, the usual outcome would simply be a corresponding reduction to the unsegregated co-owned assets of the fund. No issue of unjust enrichment arises as the expense is proportionately allocated to the participants based on their account balance.[65]

Another potential application for unjust enrichment is where participants decide to end the SMSF. At this point, the scheme property would be sold or otherwise divided between participants. While the proposed SMSF constitution may well contain guidance on how this should proceed, there could be scope for unjust enrichment to apply. The objective would be to ensure that the division of sale proceeds is appropriate where ownership of the property ends, taking into account the respective benefit and burden of the property over the course of the co-ownership.[66] However, the matter is not straightforward, as a claim would need to address the fact that extra benefits may have been enjoyed

[63] Robert Chambers, *An Introduction to Property law in Australia* (LBC Information Services, 2001) 132.
[64] Robert Chambers, *An Introduction to Property law in Australia* (LBC Information Services, 2001) 132.
[65] Proportionality is subject to possible segregation of assets to support a complying pension, in which case the expense would be applied consistent with the segregation.
[66] Beyond these situations there are limitations to unjust enrichment, since one a tenant cannot compel another to pay for benefits they confer on themselves, nor pay for benefits that they do not want.

from accepting a greater share of the ownership burden.[67] Furthermore, the issue cannot be divorced from the SMSF context, specifically the limited scope for a participant to incur extra burden in the first place, given the required separation of SMSF assets and the personal assets of its participants. Accordingly, the role for general law remedies is again limited.

6.2.4 Consequences for the SMSF

This chapter has set out the preferred solution to address the unsuitability of the trust framework for the SMSF substantiated in earlier chapters. It goes beyond the proposal in Chapter 5, which suggested an accommodative and less controversial approach to the trust. It responds directly to the need to address the SMSF substance, being a mechanism for self-directed member investment encouraged through taxation concessions but limited by restrictions contained in the SISA. Although the recommendation to adopt a purely statutory mechanism is a major development, the justification for doing so has been established incrementally, with successive chapters building the case to abandon the trust.

A number of revisions were proposed to the existing SMSF definition so as to clarify the nature of the new statutory based participant registered investment approach. This did not appear to present overwhelming difficulty. Although no longer relying on the trust, the revised definition adopted many of the existing SMSF definitional features and also emphasised that the new arrangement was a registered scheme. It was also proposed that the transition to a statutory vehicle would be assisted by clear procedural guidance surrounding the registration process. This would encourage the participants themselves to create the structure rather than outsource to professional advisers and supports the principle of self-management.

Under the new statutory framework, the SMSF is simply a platform to link the availability of a concessional taxation treatment with regulatory constraints that support the retirement income objective. Reforms to taxation laws will be necessary so as to treat the SMSF as a taxable entity, though also enabling the resulting tax liabilities to be proportionately allocated to the participants. To provide a clear break, it is suggested that SMSF regulation is moved from the SISA to dedicated legislation. In doing so, it is also an opportune time to consider the efficiencies from adopting a standard SMSF constitution and whether retirement incomes would be improved by the introduction of some level of portfolio investment restrictions.

[67] Robert Chambers, *An Introduction to Property law in Australia* (LBC Information Services, 2001) 134.

The scheme property will be co-owned by participants as tenants-in-common. Rather than rely on general property law principles, it is proposed that a statutory code of instruction for participant interactions be devised. In preparing such a statement, reference should be made to the earlier analysis of the SISA covenants in their application to the SMSF. Provided that sufficient regard is given to the context of the SMSF, many of the requirements concerning conduct, management and investment are appropriate to be continued under the new framework. To the extent that codification of these duties does not prove to be exhaustive a residual role for general law would remain.

6.3 Concluding remarks

This thesis has vigorously pursued its objective to address the suitability of the existing legal framework for the SMSF and, upon finding it deficient, has made recommendations for structural reform. An incremental approach was adopted, commencing very broadly to explain the nature of "superannuation" and the connected expression "superannuation fund". Although that may have seemed to be a trivial task, it was instructive in revealing the fluidity of their meanings and set a broad context from which the inquiry could proceed. Whilst superannuation has traditionally been associated with employment, changes in commercial and regulatory practices mean that historic definitions have become less capable of modern day application. While understanding what superannuation entails is a logical step before addressing its more technical aspects, a working description of the term proved adequate. This followed from the fact that the related expression "superannuation fund" has assumed much greater significance for taxation and regulatory purposes as the vehicle through which superannuation flows.

The definition of a "superannuation fund" has been shown to change over time, to reflect evolving taxation and regulatory approaches. Commencing with taxation law, the limited extent of early statutory restriction meant that the features of a superannuation fund largely adopted their characteristics from the general law applying to the trust. However, taxation reforms gradually changed this position, with a progression of legislative reform that demonstrated the increasing importance of statutory definitions. The regulatory role of taxation law was eventually displaced by a separate prudential enactment, wherein the SISA provided a definition of a "regulated superannuation fund". The ITAA1997 retains a supportive role by defining the characteristics of an "Australian superannuation fund" to refine the SISA definition and yield a particularly unique statutory vehicle that is eligible for a concessional taxation treatment. Beyond this definitional transformation, an historical analysis of the legislative restriction and encouragement of superannuation funds over time identifies further context as to their positioning within a broader retirement income system.

Having identified the features of "superannuation" and the important statutory basis to the "superannuation fund", the next step was for this context to be unravelled, with a particular focus on the SMSF. This vehicle is shown to have its own unique history, initially accommodated by taxation law without recourse to any dedicated statutory definition to clarify its attributes beyond those applicable to other taxation categories. The position eventually changed when the *Occupational Superannuation Standards Regulations 1987* (Cth) (OSSR) adopted the expression "Excluded Superannuation Fund" (ESF). The same expression was adopted by the SISA upon its introduction, though given its lack of detail beyond the requirement for the superannuation fund to have fewer than five members its subsequent repeal was unsurprising. The ESF was replaced by the "self managed superannuation fund", which beyond maintaining the same membership threshold contained further definitional constraints, such as the requirement that all members also be trustees of the superannuation fund. The SMSF definition, including its reliance on the trust framework, has endured and its basic conditions have not materially changed.

A statistical analysis of the SMSF (and its predecessor small superannuation fund) provided further context to this unique vehicle. The SMSF category has generally enjoyed significant growth in their number over time, though some periods of decline or stagnation have occurred and appear to correlate with changes in the extent of legislative restriction on their activities. The predominant configuration is overwhelmingly one or two members, despite the capacity to accommodate up to four members. The average assets per SMSF member account are higher than other superannuation fund categories, though investments have tended to focus on a narrower range of assets than might be expected under a modern portfolio theory. These attributes demonstrate that the SMSF sector has affixed itself as an important superannuation fund category and deserves scrutiny that its adopted legal framework is suitable for purpose.

The general law obligations that follow from the adoption of the trust were examined by reference to substance of the SMSF, identified as a mechanism for member-directed investment to be operated within certain statutory constraints. As the general law is unravelled it becomes clear that many of these obligations are not suitable. Statutory intervention to define the SMSF's existence and regulate its activities means that many of the traditional features and applications of the trust have been displaced. The role of the trust framework has been further eroded by the employment, financial and public contexts to regulated superannuation, including their particular application to the SMSF. Yet there remains a lack of consensus that the trust and the paternalistic general law duties of a trustee should be abandoned.

Beyond the tendency for superficial inquiry, the closer analysis in this thesis reveals that the contribution of fiduciary and trust law duties is easily overstated, particularly given the scope for inconsistency between the SISA statutory requirements and general law obligations. The retirement income objective reflected in the SISA has overriding importance and as a matter of interpretation should not attract the presumption of simply intending to reflect antecedent general law. Nor would this be appropriate given the substance of the SMSF, which in many instances makes trust-related general law concepts unsuitable for application. While there may be a limited interpretative role for trust law in the context of the covenants, many of those requirements can be resolved for the SMSF without such recourse.

In response to this conclusion, a positive contribution is then made by assembling two recommendations to improve the suitability of the SMSF legal framework. Both recommendations use the Government-endorsed principle of a member-focussed approach to superannuation fund regulation as a springboard, though extending it further than any past application by reference to the substance of the SMSF. The first recommendation works with the trust and employs tested statutory "control and benefit" approach to limit its features that are inappropriate for the substance of the SMSF. It would enable trust assets to be regarded as assets of the members for regulatory purposes, justifying a direct application of restrictions to the member participants rather than persisting with the veil of trusteeship. The approach is ultimately a compromise to do the best with a legal structure that is in substance not a good fit for the SMSF. The second recommendation – to abandon the trust and adopt a purely statutory form – is preferred. A statutory participant-registered investment would provide a legal structure that reflects the substance of the arrangement as a mechanism for member-directed investment.

The likelihood of the preferred recommendation being adopted in light of the current political landscape is difficult to glean. The reluctance of the Cooper Report to abandon or modify the role of the trust framework shows that the issue is not an easy one to prosecute. Yet, the Cooper Report's endorsement of a member-focussed approach to regulation, and its first guiding principle that members have effectively assumed sole responsibility for their retirement savings, provide a strong foundation. The challenge to secure change will be to push beyond superficial matters based on historic reverence, to ask why the trust is permitted to remain given its unsuitable fit with these key regulatory principles. That question will invite some broader reconsideration of the unresolved conflict between the drafting style of other principles that address the SMSF as an entity and those that remain trustee-centric.

The propensity of the Government to amend both the taxation and regulatory laws for regulated superannuation, including the SMSF, suggests that there is a willingness to pursue reforms. Adding further momentum, it is encouraging that other jurisdictions whose pension plans rely upon the trust framework have also begun to re-evaluate its role and consider alternative structures.[68] However, recent amendments do tend to suggest a preoccupation with making taxation expenditures for superannuation more fiscally sustainable. As a structural reform, the adoption of the proposed SMSF statutory framework may not be a priority. Potentially, the unresolved initiate to clarify the objective of superannuation in statute may provide a gateway to raise other more holistic issues, including whether the existing legal framework for the SMSF should be reformed. Any such opportunity should be firmly grasped, as for many people the SMSF plays a critically important part of their retirement income arrangements.

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[68] Natalya Shnitser, 'Trusts No More: Rethinking the Regulation of Retirement Savings in the United States' (2016) *Brigham Young University Law Review* 629.

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